S. HRG. 101-714

# THIRD WORLD DEBT STRATEGY

## HEARING

BEFORE THE

## SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY

OF THE

## COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

THE PROGRESS MADE IN THE PAST YEAR, ADDRESSING THE DEBT BURDEN OF THE DEVELOPING COUNTRIES

MARCH 21, 1990

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# THIRD WORLD DEBT STRATEGY

WEDNESDAY, MARCH 21, 1990

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY,

*Washington, DC.*

The subcommittee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Paul S. Sarbanes (chairman of the subcommittee) presiding.

Present: Senators Sarbanes, Dixon, Shelby, Graham, Wirth, and Heinz.

## OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. The subcommittee will come to order.

I would inform our witnesses that the Senate is in session this morning, and we will be voting from time to time. When that occurs, we will have to recess the hearings briefly in order to attend the vote, and then we will return until we complete the hearing.

Today the subcommittee on International Finance and Monetary Policy of the Banking, Housing and Urban Affairs Committee meets to review the progress made in addressing the debt burden of the developing countries since Treasury Secretary Nick Brady last year outlined a new administration strategy for responding to the Third World debt problem.

Secretary Brady's speech last March 10, just over a year ago stated, amongst other things, and I quote:

> Commercial banks need to work with debtor nations to provide a broader range of alternatives for financial support, including greater efforts to achieve both debt and debt service reduction and to provide new lending.

This call at that time for a broader range of alternatives for dealing with the debt problem, including both debt and debt service reduction, had been a policy course strongly urged by a number of Members of the Congress, and it represented on the part of the administration a significant shift from previous policies.

This morning the subcommittee will review the progress made in implementing the debt strategy since Secretary Brady's speech and the prospects for renewed economic growth in the debtor countries. The objective obviously is to enable these nations to shift from a legacy of austerity and declining living standards, which in some instances was challenging Democratic institutions in the debtor countries to a path of economic growth assuming the debtor countries put in place a series of major economic reform measures, and we hope to touch on those this morning as well.

In the past year we have seen agreements with Mexico, Costa Rica, the Philippines and just yesterday Venezuela and its creditor banks announced an agreement in principal on reducing Venezuela's $20 billion debt to commercial banks.

The subcommittee will review those agreements as they affect the debtor countries and also the possibilities or the outlook for concluding agreements with other debtor countries.

There is a temptation I think on the part of some to think that perhaps we're getting the Third World debt problem behind us. I think we've made progress, but I certainly don't subscribe to that proposition. Even those countries which have concluded agreements, in some respects their economies, perhaps in many respects, remain fragile, and we have other debtor countries that have not yet been able to move themselves onto a growth path.

Brazil, which has just inaugurated a new President, has just embarked on an ambitious economic reform program, and we'll have to see where that leads.

Argentina continues to experience very severe economic difficulties and internal difficulties in a major economic reform program.

There are a number of smaller countries still struggling with heavy debt burdens, Uruguay, Ecuador and Jamaica.

So I think this hearing comes at a very timely moment in trying to address this policy.

We are fortunate this morning to have a very distinguished group of witnesses. We will hear from them very shortly after I give my colleagues an opportunity to make an opening statement from our very able Under Secretary of the Treasury for International Affairs, David Mulford.

He will be followed by a panel of leading representatives from major banks who have been involved in the Third World debt issue, Bill Rhodes of Citibank, Rodney Wagner of Morgan Guaranty Trust Co., and Peter McPherson of the Bank of America.

We will conclude the hearing with a panel of two respected outside observers, Abe Lowenthal, the executive director of the Inter-American Dialogue and Sidney Weintraub, a Dean Rusk Professor at the LBJ School of Public Affairs at the University of Texas.

John Petty, a former Treasury official and a former chairman of the Marine Midland Bank was to be with us this morning, but he called us only yesterday to say that he has come down with the flu. So he is unfortunately on the sidelines for this hearing.

With that, I yield to Senator Heinz, a Republican colleague, and then to Senator Shelby and Senator Graham for any statements they might have.

## OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, I thank you very much.

I want to remark on one other person who isn't here with apologies to David Mulford, and that is John Walsh, who is the staff director of this subcommittee on our side, and that is because he is the proud father of a new young child, Edward Holmes, weighing in at 9 lbs., 4 oz., and 22 inches long. John is doing fine and so are the mother and son.

Mr. Chairman, I join you in welcoming our distinguished panel of witnesses, including David Mulford, and I just observe that it's likely that the countries of the developing world greeted the end of the 1980's with some genuine relief.

The decade of the debt crisis was a lost decade for many of them, when simply ending up where you started could pass for good economic performance. The question they now face is whether the 1990's are going to be any better.

The formula that is now being used to address the debt problem of course is the Brady plan. Since the signing of the Mexico agreement, many have hailed the plan with its focus on debt reduction as a great success. It's viewed with some skepticism by others who see it as providing too little relief to escape the continuing pattern of fiscal crisis and debt renegotiation that has defined the last 8 years.

We have with us today a principal architect of the Brady plan and several of the bankers who have had to put it into practice.

I look forward to hearing whether they believe we now have a blueprint for our economic policy toward the heavily indebted countries that can shift the focus from excess debt to sustained growth.

Mr. Chairman, I thank you for having this hearing at this time.

Senator SARBANES. Thank you very much, Senator Heinz.

Both Senator Shelby and Senator Graham have had a keen interest in this issue, and have not only followed it closely but have traveled in some of the debtor countries, particular in Latin America.

Senator Shelby, we would be pleased to hear from you.

Senator SHELBY. Mr. Chairman, thank you. I just want to welcome our witnesses here and look forward to hearing some of their testimony.

I think the central question here is is the plan working, and if it is working, show us how it's working because, as Senator Heinz said, there are a lot of skeptics out there.

So, David, we will want to hear from you in just a few minutes.

Senator SARBANES. Senator Graham.

## OPENING STATEMENT OF SENATOR GRAHAM

Senator GRAHAM. Mr. Chairman, I also have a statement which I would like to submit for the record.

I will state that I begin this hearing, as I have the previous hearings, with considerable skepticism as to the ultimate success of the path upon which we are embarked, and I do that in part because I believe that we are elevating process over substance.

At a previous meeting we had the benefit of the comments from Chairman Alan Greenspan, and at the time I asked what he thought the standards should be for evaluating the success of the Brady plan, and at that time he stated that he felt that the standards should be whether the debtor nations could reasonably meet their debt service requirements and have sufficient new investment to stimulate the economic growth which their countries require for political and social stability.

I have some charts which indicate a couple of the factors that Chairman Brady used as his evaluation of whether those would be achieved relating to the amount of exports as a proportion of external debt and net new investment.

Although the data stopped in 1988, Mr. Chairman, and I might say as an aside one of the concerns is the inability to get more real time and therefore policy helpful data on these countries, both of the charts indicate that we still have a considerable decline in these nations' ability to service debt and to generate either from internal or external source the funds necessary to achieve economic growth.

There have been a couple of recent articles which I would like to submit for the record on this subject. One appeared in the Los Angeles Times on February the 16 by two economists associated with the Center for United States-Mexican Studies at the University of California in San Diego.

In this these economists state, and I quote: "What never occurred in the process of devising the Brady plan was asking and answering one simple question. What is the level of debt service that Mexico can sustain while generating an economic growth rate of 6 percent a year for 6 years," which being the standard which those economists felt was necessary in order to meet the demographic and economic needs of Mexico.

The second article appeared in the Washington Post on March 14 by Frank Vogel, who is Director of Information for the World Bank from 1981 until 1990.

Mr. Chairman, I would state in conclusion that the final paragraph of Mr. Vogel's column is:

> Brady and the overall U.S. international economic strategy are in danger of being vilified across Latin America for failing to secure the expectations unleashed by the Brady plan. This is bound to damage already difficult U.S./Latin political relations. In addition, the dangers of inaction to Latin America are great and as tensions mount, given U.S. businesses' tremendous long-term potential opportunities in the region, damage will be also done to the prospects for the future U.S. economy.

That statement, Mr. Chairman, captures what I think is the context in which this issue must be viewed, and that is that the United States has more than just a commercial relationship with these countries. We have very important long-term political and strategic relationships which I believe are being severely undermined by the drift that we have experienced during the decade of the 1980's and are likely to continue to be undermined as they are today in Argentina by continuation of this process in the false hope that the Brady plan is going to be our salvation.

[The complete prepared statement of Senator Graham and the articles to be supplied for the record follow:]

COMPLETE PREPARED STATEMENT OF SENATOR BOB GRAHAM

Mr. Chairman, last March 16, Under Secretary Mulford appeared before this subcommittee to lay out the principles behind the Brady plan. The economic goals stated by Chairman Greenspan and which I expressed at that time for the Brady plan was to achieve an economic environment under which Latin American nations could reasonably meet their debt-service requirements and have sufficient new investment to stimulate the economic growth which their countries require for poltical and social stability.

Since that time, three countries have completed debt agreements under the Brady plan: Mexico, Costa Rica, and the Philippines. Venezuela, I understand, is close to

reaching an agreement. I congratulate Under Secretary Mulford and his staff for their work on these agreements.

However, I am still not sure the United States has achieved the economic and political goals for the future of the Latin American countries through the Brady plan. The Brady plan has alleviated small parts of the debt burden for the three countries, who have completed their agreements but, still have a large debt load and it is unclear whether the debt relief will be sufficient to provide adequate economic stimulus.

This lack of sufficient economic reforms may be a cause for additional political turmoil. In a recent column from the February 14 Los Angeles Times, Mr. Samuel Schmidt, [a professor of political science at the National Autonomous University of Mexico, and a visiting professor at San Diego State University], and Mr. Stephen Stamos, [a professor of international relations at Bucknell University, recently a research fellow at the Center for United States-Mexican studies at UC San Diego], say the Brady plan:

> "Agreement's reduction of debt service by approximately $2 billion a year will still leave Mexico paying almost $12 billion in debt service, which is equal to about 45 percent of export earnings. Mexico still will not have the financial resources to generate sustained and dynamic economic growth and investment."

In the article their question is:

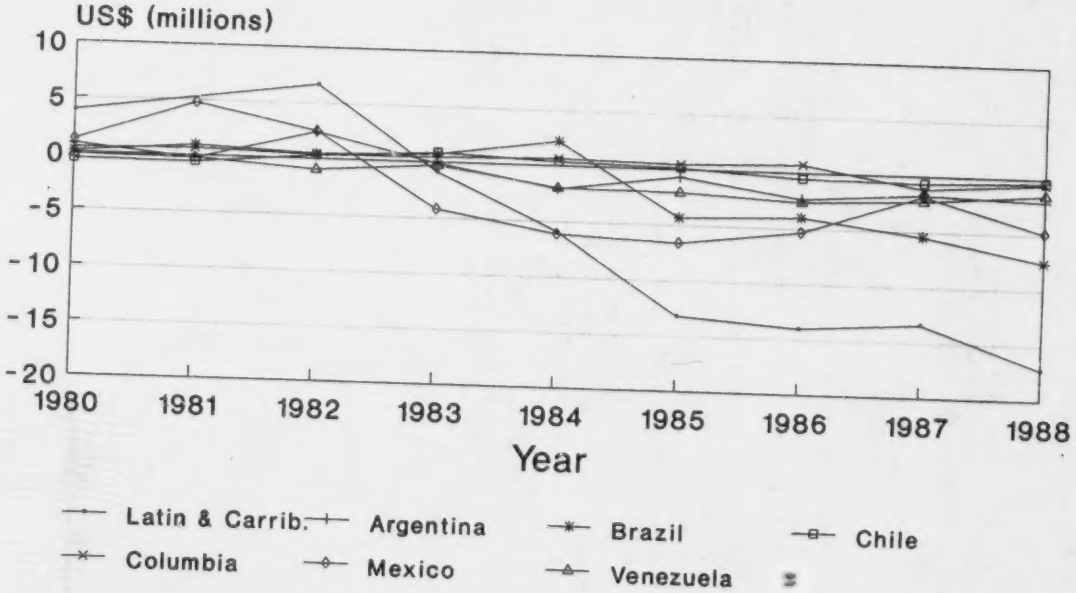
> "What is the level of debt service that Mexico can sustain while generating an economic growth rate of 6 percent a year for 6 years?"

The authors believe that if the question had been answered it would have led to a "Debt-service agreement structured to Mexico's capability to pay while it moves toward long-term goals of solvency."

Mr. Chairman, I look forward to Under Secretary Mulford's testimony today and his discussion of the goal I outlined earlier to help these countries back into sound economic positions.

CHART I

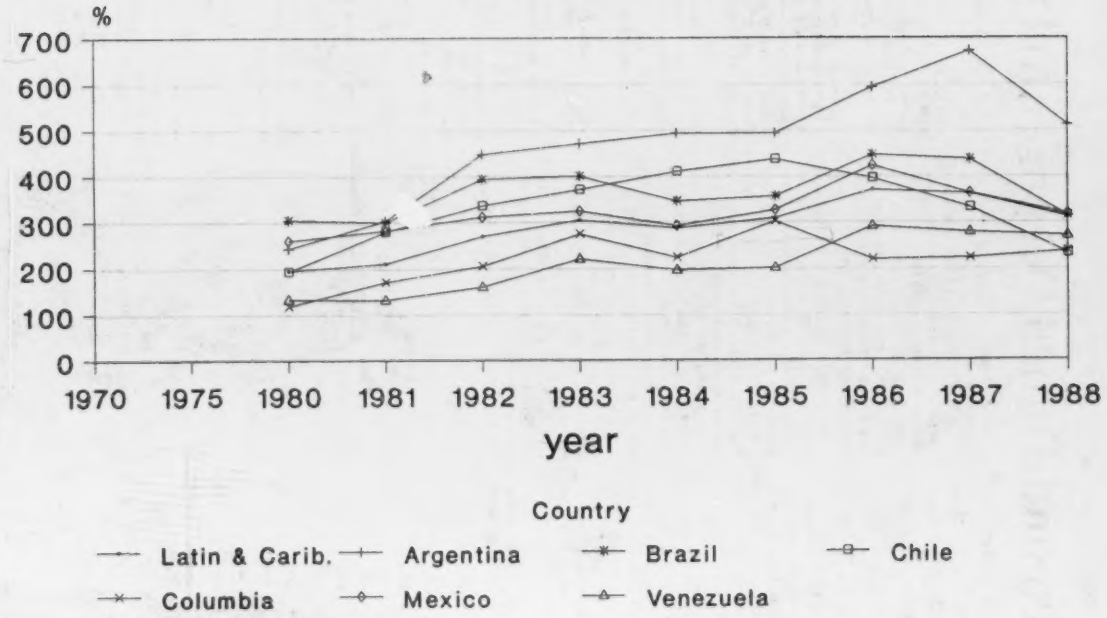
# LATIN AMERICA COUNTRIES
## Net Transfers 1980-88




Source: The World Bank -- World Debt Tables 1988-90 Edition

CHART I.

# Latin American Countries
## Total External Debt/Export G & S




Source: The World Bank --
World Debt Tables 1989-90

Los Angeles Times--February 14, 1990

# Nickeled-and-Dimed Deeper Into Debt

**In Mexico:** The U.S.-crafted deal on debt relief doesn't come close to giving the Salinas government what it needs to avert a political and economic crisis.

By SAMUEL SCHMIDT and STEPHEN STAMOS

The signing of the final agreement between Mexico and its international creditors last week is little more than yet another pause in Mexico's decade-long recession crisis.

The agreement is clearly a major short-term political victory for Presidents George Bush and Carlos Salinas de Gortari; their 1988 campaign promises for a new debt initiative have been temporarily fulfilled. For the banks, the agreement represents the success of a strategy they designed in 1988 and lobbied so successfully that by March, 1989, Treasury Secretary Nicholas F. Brady would unveil the plan as his own.

For Mexico, however, the so-called Brady plan offers very little of substance for the country's uncertain political and economic state.

Yet we are now assured by the Bush and Salinas teams that Mexico's economy will experience some stimulus from this agreement, that new loans are still possible, that capital repatriation will continue, and that the domestic economy will continue to stabilize under current policies.

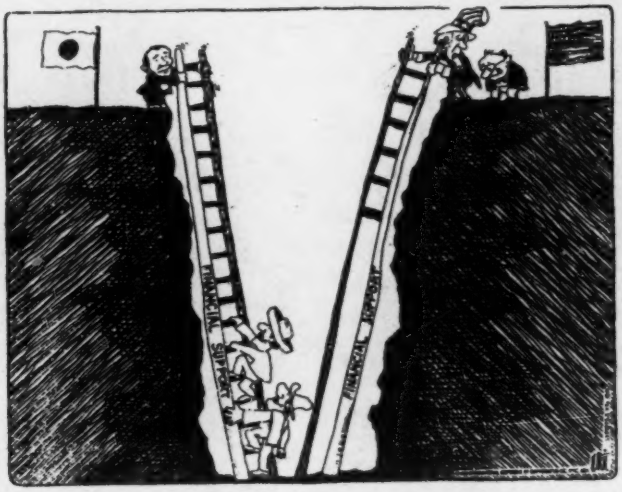
The truth of the matter is that Mexico's level of external debt will actually increase. The agreement's reduction of debt service by approximately $2 billion a year will still leave Mexico paying almost $12 billion in debt service, which is equal to about 45% of export earnings. Mexico still will not have the financial resources to generate sustained and dynamic economic growth and investment.

Salinas began his conversation with the bankers last April by asking for a level of new money and debt-service reduction amounting to $42 billion, or $7 billion per year of his term in office. Theoretically, this would have allowed the economy to grow at a rate of 6% a year. What is sad is that Salinas backed away from his early demands, to the point that by the end of July and early August it was clear for all to see that he had lost and the bankers had won.

What never occurred in the process of devising the Brady plan was the asking and answering of one simple question: What is the level of debt service that Mexico can sustain while generating an economic growth rate of 6% a year for six years? Answering this question would have led to a debt-service agreement structured to Mexico's capability to pay while it moves toward long-term goals of solvency. Instead, the bankers' goals were served; they discounted about half of the $45-billion debt that was subject to renegotiation, and gave a lower interest rate to the rest. Mexico came away with a scant $6 billion—only $1.2 billion a year—in new money. Its external debt remains a national economic crisis, and with further austerity imposed by the Brady plan, a political crisis looms as well.

The political profits will be quickly absorbed. The Brady plan is no match for the lengthening line of debtors hoping to test it for themselves. The International Monetary Fund/World Bank will eventually realize that its participation in the loan guarantees was a mistake. The Brady plan will have minimal impact on developing countries' economic stagnation, which is rooted in the structural indebtedness, which remains intact.

The problem of Third World debt still needs a genuine solution. Maybe the coming economic slowdown and escalating political instability in debtor countries, along with the rapid recognition that the Brady plan is indeed useless, will move us toward a more serious and genuine comprehensive debt-relief effort. As most debt experts will acknowledge, there is no shortage of excellent strategies and policies for such an endeavor. But there are two missing ingredients: the political will and a recognition that there is no realistic alternative to the commercial banks having to write off, without guarantees, a much larger portion of the debt.




"How come the Latin Americans trust them more than us?"

*Samuel Schmidt, a professor of political science at the National Autonomous University of Mexico, is a visiting professor at San Diego State University. Stephen Stamos, a professor of international relations at Bucknell University, recently was a research fellow at the Center for U.S.-Mexican Studies at UC San Diego.*

THE WASHINGTON POST ... WEDNESDAY, MARCH 14, 1990 F3

VIEWPOINT

# With Debt Relief Still a Dream,

By Frank Vogl

The Brady Plan is running out of gas. When Treasury Secretary Nicholas Brady announced support for Third World debt reduction plans exactly one year ago, he unleashed high expectations across Latin America. Such hopes have now turned to idle dreams.

The plan has proven to be a bitter disappointment to most South American countries, which still confront more than $430 billion in foreign debt. It has damaged the U.S. diplomatic image in the region, not that there is evidence that today's Treasury, absorbed now with Eastern Europe, appears much concerned. It has raised the prospect of increasing numbers of Latin countries taking the populist course of rejecting their foreign debt—actions that could win very short-term popularity for regional politicians and then plunge nations into economic chaos.

The Brady Plan aimed to secure negotiations that would lead to reductions of both foreign debt and debt service costs, strengthening the prospects for a revival of economic growth and thus calming the rising political and social tensions that seven years of debt crisis had unleashed in developing countries. So far, however, only one Brady Plan deal has been signed and sealed, only a few others seem likely at best and the momentum has gone out of the plan. Against this backdrop, the Treasury cannot simply look at the debt crisis as last year's problem, focus on fashionable new arenas such as Eastern Europe and be satisfied with the dismal results of its debt relief strategy.

It is time for a new and improved plan to be launched by Treasury that offers more promise of reviving Latin America's economy. Brady Plan II must be more urgent. It must involve some official U.S. funding, provide incentives to banks to be cooperative and, most important, seek to encourage foreign private investment for the debtor nations.

Mexico was the obvious first case, and no sooner had the Treasury chief announced his plan than the Mexicans, their bankers and the Bretton Woods sisters (the International Monetary Fund and the World Bank) started negotiating. It took 11 months to consummate an agreement. It came only with intense Bush administration lobbying, including President Bush's direct intervention.

The result was a reduction of Mexico's debt and debt servicing costs, but after almost a year of nonstop negotiations, the Mexicans may still have to devote $2 out of every $5 of export earnings to paying their foreign bankers. Mexico has done more these last eight years to reform its economy than any other Third World debtor, but the difficulties it had in striking a debt relief deal ensure that other debtors will have an even more strenuous time.

Venezuela's situation proves the point. It was riots in its capital, Caracas, that pushed Nicholas Brady into finalizing his debt relief proposals. Now, 13 months after those riots, the best that can be said of negotiations, as The Washington Post reported March 9, is that the country "is edging closer to an agreement."

Brady failed to get the strong backing of the Europeans for his plan. They agreed that the IMF and World Bank should put together a war chest of as much as $25 billion (the Japanese agreed to add $10 billion), but they saw no reason to directly put their own cash into the plan if the United States was not going to pay up. At the same time, the Europeans insisted that there should be tight conditions on how the war chest would be used. They were determined to ensure that commercial banks could not simply transfer their bad Third World loans to the World Bank and IMF.

The commercial banks cried foul. They expected the IMF and World Bank to provide them some direct guarantees. The banks were under pressure from the Treasury to agree to book losses on their loans, but they were given no incentive to move fast. In the interest of Latin American social, economic and political stability, there have to be some means of encouraging the banks to

# Latin America Desperately Needs a New Brady Plan

fully cooperate with debt reduction. Some tax and regulatory relief for the banks may face criticism here in the United States, but it may be essential to serve the greater good of assisting the debtor nations.

To ask the commercial banks to book losses on old loans without providing them with any incentives was a recipe for slow action, and events over the last year have proven this point. Brady, however, not only asked the banks to book losses on old loans, but he wanted them to extend new loans as well. The banks balked. Said one banker: "This is like banking under the influence of marijuana."

The plan would have been more successful if the United States had been willing to put in substantial cash of its own, instead of seeking to claim all the credit while turning to the Japanese and others for the funding. It would have been more successful if the commercial banks were given clear incentives to cooperate. And it would have worked at a faster pace if the Treasury stopped kidding itself that a free market exists to negotiate Third World debt. Brady talks about voluntary market negotiations, but the reality is that the debtors confront steering groups of commercial bankers that, working like tight cartels, speak with a single and hard voice to the developing nations.

There is no evidence that the Treasury appreciates how much of a flop its plan has become. There is no pressure within the administration to worry about most of the Latin debtors, now that Mexico has its deal. And suggestions of large-scale U.S. funding are met by arguments that the U.S. budget deficit and the needs of Eastern Europe, Nicaragua and Panama place foreign aid funds under desperate siege.

The Europeans for their part are totally preoccupied with Eastern Europe and see Latin America as squarely in the U.S. sphere of influence. The Japanese feel they have done enough on Third World debt relief by agreeing to put cash into the war chest. It will take dangerous and desperate actions by the Latin countries themselves, which will surely come in time, to force the major industrial nations to recognize that the debt crisis is still with us in the 1990s.

Solutions are bound to be complex. Tax relief for the banks to enable them to swiftly take losses on their Third World debts may not be popular, but it is the wisest option. The discounts should be substantially larger than the 35 cents on the dollar that the bankers gave Mexico. At the heart of Brady Plan II should be the establishment of investment funds, partly financed by the current debt reduction war chest and supplemented by U.S. cash through the Export-Import Bank. This would provide strong incentive to U.S. business to make direct investments in Latin America.

Reviving business investment in the debtor countries has to be the core of a new approach. The debtor countries that should benefit from such an approach would be only those willing to make the economic policy changes to strengthen their domestic environments for profitable foreign direct investment. The provision of future World Bank-IMF fast-disbursing funds to these countries should have such policy reforms as the top priority. Thus the new plan would offer realistic expectations to debtors of swift and meaningful debt relief, combined with new investment cash, in return for important policy assurances that directly benefit investors.

Brady and the overall U.S. international economic strategy are in danger of being vilified across Latin America for failing to secure the expectations unleashed by the Brady Plan. This is bound to damage already difficult U.S.-Latin political relations. In addition, the dangers of inaction to Latin America are great and as tensions mount so, given U.S. business's tremendous long-term potential opportunities in the region, damage will also be done to the prospects for the U.S. economy.

*Frank Vogl was director of information for The World Bank from 1981 until early this month. He now heads Vogl Communications Inc., an international public affairs counseling company in Washington.*

Senator SARBANES. Thank you very much, Senator Graham.
Senator Wirth.

## OPENING STATEMENT OF SENATOR WIRTH

Senator WIRTH. Thank you, Mr. Chairman.

Mr. Secretary, I am pleased that you are here. I want to echo the comments of the Senator from Florida, Senator Graham. I think he is right on the button.

I think just to further underscore that, I think there is a tendency in 1990, very natural, for the United States to focus its time and attention predominantly on what is going on in Europe, and we are obsessed with that and, second, the Japan/United States relationship which gets so much attention, and should get a great deal of attention. But lost in the shuffle, unhappily, is the kind of attention that we ought to be focusing on our north/south relationship.

It was my own belief, Mr. Chairman, that the most significant trade bill in the past was the Canada/United States agreement. That free trade agreement I hope was beginning to open the door to a much more creative north/south situation.

I think that the potential for the United States in markets north/south is enormous, but it's only going to be realized if we are able to figure out a more creative and a more aggressive way to relieve a lot of the debt service burden which is just overwhelming countries to the south and overwhelming their ability to organize with us a more vibrant trading block.

Finally, as you know, Mr. Chairman, I have been very concerned about the role of the United States and the kind of pressure that we have been putting on the World Bank and international financial institutions related to environmental decisions made by those institutions.

We have had some good luck with the Inter-American Development Bank. I think that there were some good starts made a couple of years ago in the Department of the Treasury in terms of discussions that we had with the World Bank. I think that we have not seen the kind of aggressive approach brought by the World Bank to international environmental issues and using environmental concerns as criteria for the World Bank, the kind of criteria that I would like to see and that I think was begun 2 years ago at the Treasury, but has really I hope gotten attention since then, but I would like to hear about that as well.

You and I have talked about that, Mr. Secretary, and that and the potential of debt swaps are issues that I hope we have a chance to get to today.

I'm pleased to have this hearing, Mr. Chairman. Thank you very much for putting this together.

Senator SARBANES. Thank you, Senator Wirth.

We have been joined by Senator Dixon.

Senator Dixon.

## OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Mr. Chairman, once again you're showing thoughtful leadership on the issue of Latin American international debt, and I commend you for organizing this hearing. The extensive

array of witnesses you've gathered should thoroughly cover the different perspectives on this continuing international problem.

Just a few days more than 1 year ago Under Secretary Mulford sat before this subcommittee to introduce the Brady international debt initiative and to respond to our questions about its potential efficacy.

We are here this morning to reexamine those questions and to learn about the implementation of the Brady plan to date. One year ago many of us hailed the significant policy shift which the Brady plan represented. Yet, we voiced skepticism, Mr. Chairman, that the plan would not be adequate to the task.

Today we ask: Has the plan been effective in fact? Are the negotiated results bringing enough relief to debtor countries so that they can turn the tide and begin to grow again? And why have so few countries participated thus far? Will implementation accelerate soon?

I'm concerned that honest answers to these questions suggest a disappointing prognosis. Since a year ago our world had fundamentally changed. Events in Eastern Europe and the Soviet Union ripely capture headline after headline day after day. As we adjust to this new world, and as we realize that economic competition is overshadowing military might, we should think again about the new world of the Americas.

Latin American nations are our natural geographic allies and trading partners. As their fortunes have fallen, ours, too, have diminished. This subcommittee heard convincing testimony this past fall about how our exports have fallen directly as a result of debt induced economic stagnation.

If the United States is to maintain its economic leadership in an era of rapid Asian economic growth and widening European economic common markets, it must look to its neighbors. We just clear away the barriers to growth in Latin America. We must move forward with greater speed and firmer resolve than we have to date. Bailing out the banks is no longer at issue. Advancing our trade posture and our own economic future is.

Mr. Chairman, I renew my call today for more aggressive action to address the Latin American international debt crisis.

I thank the Chair for this hearing.

Senator SARBANES. Thank you very much, Senator Dixon.

Secretary Mulford, we are ready to hear from you, and we are pleased to have you with the committee this morning.

## STATEMENT OF DAVID MULFORD, UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY

Mr. MULFORD. Thank you, Mr. Chairman.

Mr. Chairman, I would like to thank you for having these hearings and express my gratitude to you and to members of your committee for your interest in this subject, for your suggestions to us over the months and years that we have been working on this complicated problem, and for the support of the members of the committee.

I have prepared a long and comprehensive testimony for the record which I hope everybody will have a chance to study. I will

summarize those comments in a few remarks that will probably take 9 or 10 minutes, if that is all right.

Senator SARBANES. The full statement will be included in the record.

Mr. MULFORD. Last spring, as you said, Mr. Chairman, Secretary Brady launched the administration's initiative to strengthen the international debt strategy, and in the past year these concepts have been forged into far-reaching country reform programs, concrete actions by the IMF, World Bank and creditor governments, and financing packages between debtor countries and commercial banks, which include substantial amounts of debt reduction.

We should bear in mind that although the Secretary spoke 1 year ago, it took approximately 3 months to implement the plan in the international institutions. That event took place at the end of May when the Boards of both the IMF and the World Bank voted to commit the resources and set the ground rules for implementing the strategy.

In assessing our progress, I think it's appropriate to look at the last 9 months, which represents the period during which real negotiations have commenced between debtors and commercial banks.

The watershed agreement between Mexico and its commercial banks was formally completed last month with the signing of that agreement in Mexico City. Costa Rica and its creditors have reached agreement in principal on a comprehensive debt and debt service reduction package. Chile's buyback of commercial debt in November was financed by resources made available under the plan's strength and strategy. In January, the Philippines undertook a highly successful direct buyback of commercial bank debt and last month completed the new money element in its financing package with banks. A few days ago Venezuela and its creditor banks announced agreement in principle on a financing package which includes the broadest menu yet of options for debt and debt service reductions.

I would like to stress to the committee that this has happened in 9 months in what was acknowledged at the outset as one of the most complex international economic and financial issues we have faced in many, many years.

I would also like to give you one rather simple statistic which I think carries some weight. The commercial bank debt of countries so far using the Brady plan represents 44 percent of the total commercial bank debt of the 16 major debtor nations.

Let me just repeat that so that it's clear. The commercial bank debt of countries so far using the Brady plan, the so-called Brady countries, accounts for 44 percent of the stock of total commercial bank debt outstanding for the 16 largest debtor countries.

So I agree with the assessment made by the chairman that we don't have this problem behind us, but we are making very significant progress.

Senator SARBANES. If I can just interject, how many countries are you using when you account for 44 percent?

Mr. MULFORD. I'm using the so-called Baker 15, the 15 largest middle income debtors, plus Costa Rica, which has achieved a deal to make the number 16. If you take the total commercial bank debt of those countries, which is $259 billion, the countries so far that

have used the plan—Chile, Costa Rica, Mexico, the Philippines, and Venezuela—account for approximately 44 percent of that total outstanding debt.

Let me now summarize my testimony in response to the specific questions raised by the chairman in his letter inviting me to testify.

First, let me remind you that the international debt strategy has four key elements:

1. The adoption of medium-term reform programs with special emphasis on investment and capital repatriation.

2. A stronger emphasis on debt and debt service reduction in commercial bank financing packages.

3. The use of IMF and World Bank financial support to back debt and debt service reduction instruments.

4. Continued creditor government support.

This approach, as I said, has been broadly endorsed not only by the international organizations, but by major creditor nations all over the world. We agreed in the beginning that there is no solution to this problem unless there is an international consensus. Therefore we have to have a plan in operation that is supported not only by international organizations, the U.S. Government, and the Congress of the United States, but by many other countries and organizations, including the debtor countries that participate.

On Mexico, Mr. Chairman, you asked specific questions about that country's performance, and I think you are all familiar with the specific elements of the Mexican plan. So I won't go through those.

What I would like to do is give you an appraisal of the benefits of this plan for Mexico as I see it today.

The commercial bank package will generate substantial debt and debt service reduction benefits for Mexico, and I would like to elaborate these.

Over 85 percent of Mexico's bank debt will undergo substantial cuts in either interest or principal. That's 85 percent of its bank debt.

Mexico's debt obligations to commercial banks will be slashed very significantly. The total stock of bank debt, incidentally, was about $48 billion at the time the deal was done. The debt reduction bonds cut bank debt immediately by $7 billion.

The debt service reduction bonds provide the economic equivalent of a further implicit reduction in the stock of debt of $7.7 billion dollars, and up to an additional $3.5 billion of debt will be retired in the debt/equity swap program between now and 1992.

Debt service which savings amount to over $12 billion during the 1989–92 period, are as follows: Annual interest payments to commercial banks will be cut by $1.5 billion, which is nearly one-third annually, and principal amortization payments will be reduced by $6.7 billion over the period of 1989 through 1992.

Of even greater importance, the burden of principal payments on $42 billion of Mexico's bank debt, that is to say $42 billion out of $48 billion, will be lifted from the shoulders of the Mexican people.

This is accomplished because Treasury 30-year zero coupon bonds will be provided up front as collateral and will assure full repay-

ment of the remaining principal in the year 2019. Now that debt still has to be serviced, but the principal has been defeased.

Overall the Mexican Government estimates that the net effect is that total Mexican external debt will decline from $95 billion at the end of 1989 to the equivalent of $80 billion by March 1990. That is this month when the exchange is expected to take place.

Furthermore, external net transfers will be reduced by more than $4 billion annually, and that, Senator Graham, gets at your question. A net reduction in external transfers of $4 billion annually, which is equivalent to 4 percent of GNP, is a very substantial amount of resources to be freed up for productive purposes.

However, these positive results do not convey the full importance of the Mexican agreement. To undertake a complete assessment, one needs to compare these positive results with the results that would have flowed from the old debt strategy, the all new money solution of the past.

I would like to just run through that for a moment. Of course this depends on a number of assumptions. Our estimate is that had we used the old plan, Mexico's total debt would have risen by $7–8 billion instead of declining by something like $16 billion, a rather substantial swing of $23–$24 billion.

None of the debt would have been defeased. In other words, the $42 billion in principal payments would not have been lifted from the shoulders of the Mexican people. The medium-term time horizon of this package of 4 years, instead of the short 12 to 18 months of the previous new money financing packages, is obviously longer and gives Mexico a longer timeframe in which to make its adjustments.

Furthermore, the benefits of the new plan extend well beyond 1992 because the reductions in interest payments under the plan are permanent for 30 years, and the defeasance of course is a permanent feature.

Next, the 4 percent of GDP, which I mentioned before has been freed by this plan, would still be locked up in debt service payments under the old plan. So there is a significant availability of resources to be used in the Mexican economy to finance growth, to finance imports, and to help us recover our markets. This has already begun to happen.

The fact that virtually all of Mexico's commercial banks participated in this package contrasts sharply with the old practice where there were huge numbers of free riders. In this case virtually every bank came in and took part in the plan.

And, Mr. Chairman, under the old plan, $7.5 billion of new money would have been required, I don't think it would have been possible to raise that money from the banks because the banks at that point were clearly withdrawing. That was one of the reasons for changing the debt strategy.

Finally, Mr. Chairman, there are the economic benefits of the plan to Mexico which run beyond the mere act of debt reduction. We have already seen these benefits: Declines in domestic interest rates; savings on the servicing of the Government's domestic debt; a reduction of the fiscal deficit in Mexico equivalent to 4 to 5 percent of GDP; net capital inflows in 1989 of approximately $3 billion and; growth, which was expected to run between 1 and 2 percent

and has already risen to 2.5 percent in 1989. Our current projection is that these benefits will help produce growth for Mexico of between 5 and 6 percent annually by 1994.

Senator SARBANES. Mr. Secretary, I think I had better interrupt you right at that point. We have a roll call vote underway. I think the second call will sound very shortly, and I think we will recess the hearing briefly and return for the balance of your statement and then for questions.

Mr. MULFORD. Thank you.

Senator SARBANES. The hearing will stand in recess for time needed to vote.

[Recess.]

Senator SARBANES. The subcommittee will resume the hearing.

Mr. Secretary, if you would continue with your statement, we will be pleased to hear the balance of it.

Mr. MULFORD. Thank you, Mr. Chairman. Let me try to bring this to a close fairly quickly.

I would just note that other countries that have reached important agreements are the Philippines and Costa Rica. I won't go through the details of their agreement here this morning, but I would be willing to respond if you raise those packages in questions.

On Venezuela let me just make a few remarks. As I and you said earlier, Venezuela and its creditor banks reached an agreement in principal a day or two ago, and this is a comprehensive agreement which will include significant new money features as well as several debt and debt service reduction options.

During the past year the Government of Venezuela has been implementing the most comprehensive economic adjustment program in its history. The elements of the agreement with commercial banks include a cash buyback program at a price to be set by Venezuela and the banks taking into account the secondary market price of Venezuelan debt, a principal reduction bond at a discount of 30 percent and an interest reduction bond with an interest rate of 6¾ percent. The last latter two options would be in the form of a 30-year bond with principal collateralized by zero coupon bonds and 14 months of interest support.

Another option is a temporary interest reduction option. Under this option the banks would exchange their debt for a 17-year bond with reduced interest rates of 5 percent for the first 2 years, 6 percent for 3 and 4 years and 7 percent for the fifth year, and a market rate thereafter.

Finally, under the new financing option during the period of 1990 to 1992, the banks would exchange existing debt obligations and provide new money for bearer bonds which would result in a 20 percent increase in exposure for banks selecting this option.

It's too early, Mr. Chairman, to assess specific results and therefore the specific benefits of this financing package to Venezuela because we cannot at this time estimate the likely response from individual banks to the various options that are provided.

I would note, however, that this agreement does provide the broadest range of options yet offered under the strategy, and I think it's an imaginative and impressive package.

You asked, Mr. Chairman, for brief remarks on Argentina and Brazil. Among the major debtor nations, Brazil and Argentina are the largest countries that have yet to make significant progress under the strengthened debt strategy. This essentially is the result——

Senator SARBANES. Could I just interject there. The five countries were 44 percent of the total. How much is Brazil and Argentina put together, do you know?

Mr. MULFORD. If Brazil were to be added to the five countries that I mentioned in terms of percentage, it would raise the percentage of commercial bank debt from the 44 percent figure I gave you to 71 percent. Argentina would account for it looks like about another 12 percent. So that would raise it more than 80 percent if those two countries were to come in under the plan.

Senator SARBANES. OK.

Mr. MULFORD. In the case of Argentina, Mr. Chairman, the Government has been preoccupied for the last 8 months with stabilizing the nation's economy, a process that has clearly remained elusive to this time. While the Government has held preliminary discussions with its commercial banks, it cannot focus on serious negotiations as long as the domestic situation remains unstable. The negotiations with commercial banks once they begin will also be very severely complicated by the existence of some $6 billions of arrears to the banks which have developed since April 1988.

We do not expect progress in these negotiations with the commercial banks until Argentina can show progress in implementing far-reaching economic reforms.

In the case of Brazil, Mr. Chairman, last week the President of Brazil announced and launched a new program for economic reform. In general terms the program looks bold and very strong to us. We are now in the process of studying this program, and we look forward to discussing it with the Brazilian authorities at the earliest opportunity.

We also understand that they are developing a number of ideas for handling their debt situation. Brazil will need a comprehensive, medium-term financing package including a wide range of menu options for debt and debt service reduction. We understand the banks want to meet with the Brazilians and begin negotiations early, particularly because of the existing and potentially mounting arrears problem.

In closing, Mr. Chairman, I would like to look ahead for a moment, as you suggested that I do, by making the following points.

In these past 9 months, both debtor nations and commercial banks have had to adjust their expectations. The initial expectations of debtor countries for debt relief after Secretary Brady made his speech were high, while the extent of acceptance of debt reduction varied quite considerably from bank to bank.

I believe both groups are now coming to terms with the realities of the situation in each country and the realities of the market. Debtor countries are recognizing that debt relief alone is not a panacea and that sound policies are essential to address their economic problems. Commercial banks have also acknowledged the need for

diversifying options, and that innovative forms of new lending are still possible.

Over the long term the success of this approach will depend on several factors. Reform efforts will have to be sustained in the countries that engage in this process or the benefits of debt and debt service reduction will be squandered.

Both banks and debtor nations need to avoid the temptation to fund financing gaps through arrears. Such a temporary and illusory solution would only undermine the reform effort, dissipate market and investor confidence, and in the end replace cooperation with confrontation.

A case-by-case approach with flexibility for individual countries remains essential, and we must continue to recognize that there are no easy, all-encompassing global solutions.

As I said at the beginning of my remarks, I think the progress is impressive, and a number of important developments have already occurred.

First, the strategy has renewed the resolve in many debtor countries to complete the adjustment process.

Second, it is clear now that the debt strategy is flexible. It can respond to specific country circumstances, whether the debtor is large or small or close to returning to voluntary lending. It can offer commercial banks a wide range of options to suit their particular needs.

Next, the agreements in Mexico, the Philippines, and Venezuela indicate that new bank lending and debt reduction can indeed coexist in the same financing packages.

Fourth, important economic results are clearly one of the benefits for the debt reduction effort. When debt and debt service reduction is combined with policy reform, positive economic results appear very quickly. The strategy clearly has the potential to extract debtor countries from the spiral of constantly escalating debt. This will not only free up resources for productive investment, but will also boost optimism in the debtor countries that sustained economic development and improved living standards are still achievable targets and not just etherial goals.

And, finally, Mr. Chairman, by combining fundamental economic reform in the debtor countries with substantial debt and debt service reduction by commercial banks, there is now a realized hope that flows of capital in the form of repatriated flight capital and direct investment will be provided as the new finance needed by debtor countries to sustain their recovery.

This result offers a far more credible solution for long-term growth than a perpetual dependence on new rounds of concerted lending by unwilling commercial banks or, indeed, than would be provided by some single global solution dictated by governments that kills all hope of continued private financing and capital reflows.

Thank you very much, Mr. Chairman.

[The complete prepared statement of Under Secretary David Mulford follows:]

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Statement of the Honorable
David C. Mulford
Under Secretary of the Treasury for International Affairs
before the Subcommittee on
International Finance and Monetary Policy
of the
Committee on Banking, Housing, and Urban Affairs
U.S. Senate

Last spring Secretary Brady launched the Administration's initiative to strengthen the international debt strategy. In the past year, these concepts have been forged into far-reaching country reform programs, concrete actions by the IMF, World Bank and creditor governments, and financing packages between debtor countries and their creditor banks which include substantial reduction of debt and debt service burdens.

The watershed agreement between Mexico and its commercial banks was formally completed last month with the signing ceremony in Mexico City. Costa Rica and its creditors have reached an agreement in principle on a comprehensive debt and debt service reduction package. Chile's buyback of commercial bank debt in November was financed by resources made available under the strengthened debt strategy. Last month, the Philippines completed its new financing package with commercial banks, which included a highly successful direct buyback of commercial bank debt. Earlier this week Venezuela and its creditor banks announced an agreement in principle on a financing package which includes a broad range of options for debt and debt service reduction.

I am thus pleased to inform the Subcommittee that the strengthened debt strategy is very much alive and well. My progress report today will reiterate the objectives of the strategy, outline creditor government actions, detail the reform efforts in some of the debtor countries, and focus on the design and benefits of the financing agreements in Mexico, Costa Rica, and the Philippines. I will also summarize the elements of the recent Venezuelan package, as we understand them, and touch on the prospects for Argentina and Brazil.

Objectives of the Debt Strategy

The major tenet of the debt strategy can be summarized in one sentence: Highly indebted countries must successfully implement market-oriented macroeconomic and structural policy reforms in order to achieve sustained growth and ultimately resolve their debt servicing problems. In advancing the strengthened debt strategy, our key objectives are to:

- Reinvigorate the policy reform efforts in the highly indebted countries. While a number of the major debtors initiated vital macroeconomic and structural reform programs, by the end of 1988 efforts to sustain these programs in several countries were stalled by debtor fatigue and pessimism. The strengthened debt strategy, by offering the prospect of significant debt and debt service reduction by the commercial banks, has provided important incentives for many debtor countries to maintain difficult but essential reform efforts. The strategy reaffirms the role of the IMF and the World Bank in encouraging strong debtor reforms, in particular measures to encourage repatriation of flight capital and investment.

- To mobilize financial resources from the private sector more effectively in support of debtor reforms. By the end of 1988, new lending from commercial banks had virtually dried up, banks were disposing of their LDC exposure in the secondary market, and low investment and continued capital flight hobbled economic growth in debtor countries. The strengthened debt strategy is designed to harness commercial bank willingness to engage in debt and debt service reduction for the benefit of debtor countries, as a complement to new lending by a smaller group of banks, and to develop measures to promote new investment and capital repatriation.

- To redirect IMF and World Bank resources to back debt and debt service reduction for commercial banks. In order to strengthen the capacity of the IMF and World Bank to promote meaningful reform programs in debtor countries, the strengthened debt strategy permits debtor countries to use resources from the international financial institutions (IFIs) to back the reduction of debt and debt service by commercial banks. IFI resources can be used to finance cash buybacks of bank debt, to purchase collateral for debt and debt service reduction instruments, and to provide limited interest support for such instruments.

- To provide continued creditor government support. Creditor governments continue to play an important role under the strengthened debt strategy through their contributions to the international financial institutions, rescheduling of official debt in the Paris Club, ongoing export finance, and efforts to reduce (where appropriate) impediments to debt

and debt service reduction stemming from tax, regulatory, and accounting regimes.

The strengthened debt strategy has been broadly endorsed by the international community. Last May, the IMF and the World Bank moved expeditiously to adopt guidelines governing their support for debt and debt service reduction. Several debtor countries have subsequently adopted medium-term, market-oriented economic reform programs, with greater recognition of the importance of measures to promote investment and capital repatriation. This is the first essential step in the process.

The second step for most countries has been the negotiation of multiyear rescheduling agreements with official creditors in the Paris Club. The final step -- negotiations with commercial bank creditors -- has now been completed for four countries -- Mexico, the Philippines, Costa Rica, and now Venezuela. Morocco is now actively negotiating with its banks. Other countries are moving to avail themselves of similar support within the next year as they adopt strong medium-term economic reform programs with the IMF and World Bank. These countries include Bolivia, Nigeria, Ecuador, and Uruguay. The new president of Brazil is putting together his program after his inauguration last week.

Role of Creditor Governments

Creditor governments have moved rapidly to support the strengthened debt strategy. At their urging, the IMF and the World Bank developed and put into place guidelines for IFI support for debt and debt service reduction. A number of creditor countries have pledged financial support to enhance specific financing packages. The Government of Japan is in the process of providing $10 billion to support the strengthened debt strategy with specific commitments so far for Mexico, the Philippines, Costa Rica, and Venezuela. The United States, through USAID, has provided concessional resources to both the Philippines and Costa Rica to back debt and debt service reduction. In addition, official export credit agencies continue to provide critical trade finance to many of the major debtor countries.

Creditor governments have also made substantial contributions through Paris Club reschedulings. Reflecting the medium-term horizon of the debt strategy, the focus of the Paris Club is now on multi-year rescheduling agreements (MYRAs) for the debtor countries. Since in many cases creditor governments have been willing to reschedule interest as well as principal on official loans, the official reschedulings have continued to provide "new money" and therefore more relief than bank reschedulings. Official relief continues to be available only for countries with an IMF adjustment program.

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The U.S. Government and other official creditors are also providing special treatment ("Toronto terms") to the least developed countries which are pursuing sound economic reform programs. In addition, the U.S. government has announced a willingness to forgive up to $1 billion in economic assistance loans to Sub-Saharan African countries pursuing economic reform programs. Congress has provided for this purpose in an appropriations act, nine countries have signed agreements, and four more countries have been declared eligible for the program.

Creditor governments have also initiated efforts to identify and, where appropriate, remove any impediments to debt and debt service reduction in their tax, regulatory, and accounting regimes. In the United States, the Securities and Exchange Commission has clarified the accounting treatment for the debt reduction bonds and debt service reduction bonds held by banks as a result of the Mexican financing package. In addition, the Department of the Treasury has clarified the tax treatment of the new bonds, in particular the determination of the amount of the tax loss. Neither the SEC clarification nor the Treasury clarifications break new ground, but instead rely on longstanding standards and rules to remove uncertainties as to how these financial instruments would be treated.

I would now like to touch on specific developments in individual debtor countries.

Mexico

Mexico has maintained a strong record of implementing macroeconomic and structural reforms in its efforts to resolve its debt problem. Mexico's past adjustment performance -- exchange rate reform, tax reform, liberalization of its trade regime, industrial diversification, and measures to reduce the fiscal deficit and curb inflation -- has provided the backdrop for economic recovery. However, the fall in oil prices in 1986, following on the 1985 earthquake, disrupted Mexico's economic progress. While the Mexican economy has been recovering from these shocks, growth has been sluggish, key debt ratios have remained high, and substantial financing gaps have persisted even after significant adjustment in the trade balance.

The Administration of President Salinas has pressed forward with reform efforts, including efforts to reduce the size and scope of the public sector. Recently, Mexico has taken measures to privatize the state airline, its major copper mine, and the state telephone company (one of the five largest companies in Mexico). Deregulation has been pressed in the trucking industry and the financial sector. New regulations have significantly liberalized Mexico's foreign investment regime. These regulations streamline and expedite registration requirements, increase the transparency of Mexico's foreign investment laws, reduce performance

requirements, and open up areas formerly excluded from foreign participation.

Mexico's agreements with its key creditor groups incorporate all elements of the strengthened debt strategy:

- Strong macroeconomic and structural reforms as conditions for drawing IMF and World Bank resources;
- Meaningful debt reduction;
- Substantial debt service reduction;
- New money;
- Bank waivers to permit subsequent debt buybacks;
- Full participation by commercial banks;
- IMF and World Bank enhancements in support of debt and debt service reduction;
- Substantial debt/equity swaps;
- Capital repatriation; and
- Multiyear Paris Club rescheduling.

Mexico and its creditor banks completed negotiations on a comprehensive medium-term financing package in July 1989. Signature of the final agreement started last month, with the actual exchange of debt instruments expected by the end of March. The financing package provided commercial banks with a choice of vehicles to participate:

- Debt Reduction Bonds that replace existing medium-term debt at a discount of 35% with full repayment occurring in 30 years.

- Debt Service Reduction Bonds that carry a fixed interest rate of 6.25% with full repayment occurring in 30 years.

- New financing during 1989-92 equal to a total of 25% of existing exposure that has not been converted into debt and debt service reduction instruments.

The debt reduction and debt service reduction bonds are supported by enhancements totaling $7.1 billion from the IMF, World Bank, Japan, and Mexico's own resources. The principal of both bonds will be fully secured by collateral in the form of 30-year zero coupon bonds. Interest payments will be enhanced by 18 months of rolling interest support.

The United States Department of the Treasury will sell Mexico sufficient non-marketable 30-year zero-coupon Treasury bonds to be used as collateral for these transactions. Pricing zero-coupon bonds is complicated by a number of factors. At the time of the pricing Treasury had only issued non-marketable zero coupon bonds on two other occasions -- the Morgan/Mexican debt reduction deal in 1987-88 and the initial issue of zeros to REFCORP in October, 1989. Furthermore, Treasury has not itself

issued zero coupon bonds directly in the public market. The Treasury STRIPS market, a derivative market resulting from the stripping of Treasury coupon instruments by market participants, remains smaller than the coupon market and somewhat volatile. As a result, there were few pricing precedents and no easy or obvious market guidance since a number of possible pricing benchmarks exist.

The Treasury pricing decision for the zero-coupon bond for Mexico was based on principles reflecting both the size of the Mexican transaction and the precedent of the 1987-88 Mexican purchase of zeros. The earlier Mexican deal was priced off the coupon rate because the STRIPS market was deemed to lack sufficient depth and the size of the transaction was large relative to the then outstanding STRIPS market. The current transaction size of approximately $35 billion face amount is even larger relative to the STRIPS market today. Treasury judged that the STRIPS quotation would again be inappropriate for pricing a transaction of this size and scope. The existing STRIPS yields would be severely affected if a transaction the size of the $35 billion face amount of Treasuries for Mexico were issued in the public market. It is likely that the STRIPS yields would be driven toward the coupon yields.

The specific pricing formula for the Mexican transaction involved the average 30-year U.S. Treasury coupon borrowing rate for the 3-day period ending January 5, 1990 of 8.05%. A fee was charged by Treasury in the form of an adjustment of the annual yield by 1/8%, which is identical to the fees charged for Treasury special issues over many years. The Treasury's final borrowing rate from Mexico was 7.925%.

Benefits to Mexico of its Agreement with Commercial Banks:

The commercial bank package will generate substantial debt and debt service reduction benefits for Mexico:

- Over 85% of Mexico's bank debt will undergo substantial cuts in interest or principal.

- Mexico's debt obligations to commercial banks will be slashed significantly:

  - -- The debt reduction bonds cut bank debt immediately by about $7 billion.
  - -- The debt service reduction bonds are the economic equivalent of a further implicit reduction in the stock of debt of $7.75 billion.
  - -- Up to an additional $3.5 billion of debt will be retired in the debt/equity swap program by 1992.

- Debt service savings total over $12 billion during the 1989-92 period.
  - -- Annual interest payments to commercial banks will be cut by $1.5 billion (nearly one-third).
  - -- Principal amortization payments will be reduced by $6.7 billion over this period.

- Of even greater importance, the burden of principal payments on $42 billion of Mexico's bank debt are lifted from the shoulders of the Mexican people; this is because Treasury 30-year zero-coupon bonds provided as collateral up front will assure full repayment of the remaining principal amounts of both the debt and debt-service reduction instruments in 2019.

- Overall, the Mexican Government estimates that the net effect is that Mexico's total external debt will decline from $95 billion at the end of 1989 to the equivalent of $80 billion in March 1990. Furthermore, external net transfers will be reduced by more than $4 billion annually, which is equivalent to 4% of GDP.

However, these positive results do not convey the full importance of the Mexican Agreement. To complete the assessment, it is necessary to compare these positive results with the results that would have flowed from the type of all new money solution that characterized the previous debt strategy:

- Mexico's total debt in 1992 would have been some $24 billion higher than will now be the case, if we include the implicit effect of debt service reduction.

- Rather than perpetually rescheduling principal, the new agreement's defeasance arrangement removes from Mexicans the burden of future principal payments on $42 billion of Mexico's bank debt.

- The medium-term time horizon of this package (four years) increases the stability of Mexico's economic and investment climate, as compared to the traditional 12-18 month financing pact, which we found could take most of that time to put together. Furthermore, the annual benefits of reduced interest payments, debt reduction, and defeasance extend well beyond the 1989-92 period of the package.

- The new agreement frees up substantial Mexican resources for productive investment (about 4% of GDP), which otherwise would be used to service ever-growing debt.

- The fact that virtually all of Mexico's commercial banks participated in this package contrasts sharply with the growing free rider problem under the old strategy. Finally, there is no doubt that if the old strategy of concerted new lending had been tried for Mexico, the equivalent of $7.5 billion in new money would not have been forthcoming. It was clear by the end of 1988 that most banks had decided to withdraw from providing fresh money to debtor countries. This was one of the key reasons for changing the old debt strategy.

The final and perhaps most notable benefit of the agreement is the growing confidence in Mexico's economy. Since the agreement was announced last summer, domestic interest rates have fallen, resulting in savings on servicing the government's domestic debt and a reduced fiscal deficit equivalent to 4-5% of GDP. In addition, net private capital inflows in 1989 totalled about $3 billion, indicating increased investor confidence. These positive developments, combined with Mexican reform efforts, have contributed to an expansion in the Mexican economy. Growth has increased from 1.1% in 1988 to an anticipated 2.5% in 1989. The economy is expanding at a fairly rapid pace, with substantially lower inflation.

These early indicators bode well for Mexico's capacity to achieve sustainable growth in the future. Current projections are that these benefits will help produce growth of 5-6 percent by 1994 and will halve Mexico's debt service and interest service ratios. For these benefits to crystallize, it will be vital for Mexico to sustain its reform efforts.

Other Financing Packages

The strengthened debt strategy is designed to be flexible and responsive to individual debtor country needs. As a result of the case-by-case approach, the financing packages which emerged from debtor/bank negotiations in the Philippines, Costa Rica and Venezuela differ markedly from the Mexican package.

The agreement between the Philippines and its commercial banks places greater emphasis on new money and direct cash buybacks because Philippine conditions are materially different from those in Mexico. The Philippine economy has realized steady growth for a number of years and its debt burden is not as heavy as Mexico's. The Philippines also is the beneficiary of substantial foreign assistance commitments for the period ahead. The impact of debt and debt service reduction would have been small relative to Philippine financing needs because medium-term bank debt only accounts for about 25% of total Philippine indebtedness.

These factors are reflected in the agreement reached between the Philippines and its commercial banks. New lending was necessary to fill projected financing gaps, while direct cash buybacks were an efficient means of enlisting the support of banks prepared to exit the Philippines at a steep discount. The elements of this agreement include the following:

- The Philippines completed a direct buyback of $1.3 billion in early January at a 50% discount. This is equivalent to a 20% reduction in its stock of medium-term commercial bank debt. The buyback was funded by IMF, World Bank, Philippine and official support totaling $667 million (including $95 million from the U.S. Agency for International Development).

- Banks rescheduled remaining outstanding debt.

- Voluntary new lending from commercial banks amounted to about $700 million.

- Commercial banks have rescheduled the remaining debt and have granted waivers to permit the Philippines to launch additional debt and debt service reduction arrangements.

This agreement offers substantial benefits to the Philippines. It fills the projected financing gaps for 1989-90 while achieving net debt reduction. After taking into account the substantial new lending contemplated, we estimate that the net debt reduction and the net debt service reduction on bank debt will still amount to 10%. Because the net debt reduction is permanent, these benefits will extend well beyond 1990. Further reduction of commercial bank debt is contemplated since the Philippines has committed to reopen its debt/equity swap program and expects additional debt and debt service reduction operations as a result of broad commercial bank waivers. These longer-term benefits should help to stabilize the medium-term economic and investment climate in the Philippines, provided of course that the Philippine government successfully implements needed reforms in its investment policies.

The debt strategy is not only flexible enough to accommodate different debtor profiles, but is also designed to apply to smaller debtor countries such as Costa Rica. Costa Rica has a heavy debt burden and has significant projected financing gaps for several years. Negotiations with commercial banks were also complicated by Costa Rica's arrears problem, accounting for $325 million of $1.8 billion owed commercial banks.

In October 1989, Costa Rica reached agreement with its Bank Advisory Committee on a package we expect will be completed by spring 1990. The financing agreement deals effectively and stringently with the arrears problem, while realistically

recognizing the limits on Costa Rica's capability to service its bank debt. Elements of the agreement include:

- A projected cash buyback of outstanding debt, including arrears, at an 80% discount.
- An exchange of the remaining principal for a par bond with a reduced interest rate of 6.25%.
- Substantially less favorable treatment for the remaining arrears, which requires a 20% downpayment on the outstanding balance by Costa Rica, rescheduling of the balance for 15 years in a mortgage-style bond, and a market rate of interest.
- IMF, World Bank and official support to fund the buyback and provide interest support for the par bond.
- Principal is not collateralized in this transaction.

Given the depth of Costa Rica's discount, the direct benefits of the financing package to Costa Rica are very substantial. We estimate that the arrangement, when implemented, would retire about 60% of Costa Rica's bank debt and reduce interest payments by about 60% annually. The agreement will put the troublesome arrears problem behind Costa Rica, and reduce Costa Rica's debt service burden to a level which reflects more realistically its ability to pay.

Venezuela and its creditor banks reached an agreement in principle earlier this week on a comprehensive financing agreement which included both a significant new money feature as well as several debt and debt service reduction options. During the past year, the Government of Venezuela has been implementing the most comprehensive economic adjustment program in its history. The purpose of the program is to eliminate distortions in the Venezuelan economy and to open the economy for international trade and investment. The bank financing package provides financial support for this adjustment effort. Elements of the agreement include:

- A cash buyback program at a price to be set by Venezuela, taking into account the secondary market price of Venezuelan debt.
- Principal reduction bonds at a discount of 30% and interest reduction bonds at an interest rate of 6.75%. Both of these options would be in the form of 30-year bonds, with principal collateralized by zero-coupon bonds and 14 months of interest support. Warrants would be included with each bond giving the holder the right to value recovery payments after 6 years if Venezuelan

crude oil prices exceed a specified price, up to a ceiling specified in the warrants.

- Temporary interest reduction. Under this option, banks would exchange their debt for a 17-year bond with reduced interest rates of 5% for the first two years, 6% for the third and fourth years, 7% for the fifth year, and a market rate thereafter.

- New financing during the period 1990-92. Banks would exchange existing debt obligations and provide new money in the form of bearer bonds, resulting in a 20% increase in exposure for those banks selecting this option.

It is too early to assess the specific benefits of this financing package to Venezuela because we can not at this time estimate the likely bank response to the options available under this package. I would note, however, that this financing package contains the broadest range of options yet offered under the debt strategy.

The new debt strategy was also used by Chile to implement its direct cash buyback in November. Chile chose not to enter into broad debt reduction negotiations with commercial banks because it is close to recovering voluntary access to financial markets and its earlier debt conversion programs were very successful in reducing its commercial bank debt. Instead, Chile completed a limited direct buyback, using resources from the international financial institutions to purchase $140 million in commercial bank debt at a discount of 41%. The buyback should be viewed as the latest stage of the Chilean debt reduction program. Since 1985, Chilean debt/equity swap and buyback programs have retired $7.8 billion in debt, equivalent to over half of its medium- and long-term commercial bank debt at end-1985. In many ways, Chile could be viewed as the laboratory for the strengthened debt strategy. The Chilean experiment indicates that a strong commitment to reform combined with reduction in bank debt can result in normalization of debt service and sustainable growth.

Prospects for Argentina and Brazil

Among the major debtor nations, Brazil and Argentina are the largest countries that have yet to make significant progress under the strengthened debt strategy. This lack of progress does not reflect adversely on the debt strategy, but instead stems from protracted delays by both countries in implementing appropriate economic adjustment policies.

The IMF will need to play a crucial central role in providing a framework for economic adjustment in both these countries. Resources from the World Bank and the Inter-American Development Bank will also help promote structural and sectoral adjustment.

Argentina and Brazil remain candidates for the strengthened debt strategy, once they have established credible domestic economic policies with the help of an IMF-supported adjustment program. A full range of options for debt and debt-service reduction could then be exercised for both nations.

Argentina. The government of Argentina has been preoccupied for the last eight months with stabilizing the nation's economy, a process that remains elusive. While the government has held preliminary discussions with its commercial bank creditors, it cannot focus on serious negotiations as long as the domestic situation remains unstable. Negotiations with the commercial banks, once they begin, will also be complicated by the existence of some $6 billion in arrears to banks since April 1988. We do not expect progress in negotiations with commercial banks until Argentina can show progress in implementing far-reaching economic reforms.

Brazil. Since falling out of compliance with its IMF standby arrangement in late 1988, Brazil's economy and its relations with the international financial community have deteriorated. In February 1990, inflation reached a monthly record of 73% and the 1989 budget deficit stood at about 7% of GDP. Brazil's inability to revive its standby led to the withholding of a $600 million new money tranche from creditor banks and to a halt in policy-based lending from the World Bank. Most bilateral credits have also been frozen.

The Brazilian government imposed a de facto moratorium on interest payments to creditor banks last September to conserve liquid reserves prior to the Presidential election. Interest arrears to creditor banks now exceed $5 billion.

Last week the President of Brazil launched a new program for economic reform. We are now studying this program and look forward to discussing it with the Brazilian authorities. We also understand that they are developing a number of ideas for handling their debt situation. Any financing package would need to address as a matter of priority Brazil's interest arrears. In our view, Brazil will need a comprehensive, medium-term financing package, including a wide-ranging menu of options for debt and debt-service reduction. The first priority, however, is the successful implementation of Brazil's economic program.

Assessment of the Debt Strategy

The financing agreements to date feature the new mechanisms for commercial bank support anticipated by the strengthened debt strategy and furnish new incentives for sustaining sound policies in debtor economies. The Mexican, Costa Rican, and Venezuelan packages assured comprehensive support by the full banking community, while the Philippine and Chilean arrangements focus on

selective debt reduction. Good performance deserves such support by the commercial banking community. Debtor nations cannot resolve their external debt problems through their own efforts alone.

Practical implementation of the strategy has required an adjustment of expectations by both the debtor nations and commercial banks. Initial debtor country expectations of debt relief were high, while the extent of acceptable debt reduction varied from bank-to-bank.

My own sense is that many debtor countries and commercial banks have been coming to terms with the new reality. Debtor countries are recognizing that debt relief alone is not a panacea for their economic problems. Sound policies are the essential prerequisite for success. In the agreements negotiated thus far, commercial banks have acknowledged that their diversified interests can only be reconciled through diversified options, that innovative forms of new lending are still possible, and that debt and debt service reduction for performing countries can support adjustment and improve the quality of their remaining claims.

Looking ahead, I would offer a note of caution to debtor nations and commercial banks alike:

- Debtor nations can not afford to relax their adjustment programs simply because they may be able to obtain a measure of debt relief. If the reform process is not sustained, these countries will have squandered their best opportunity to put their debt problems behind.

- The strong reserve position of commercial banks, which we commend as financially prudent and conducive to debt reduction, should not be used as a screen for failing to negotiate solutions with the debtor countries. Perpetual reschedulings, with minimal debt reduction, debt service reduction or new lending, can only contribute to future arrears and undermine the reforms needed for sustained growth.

- Both debtor nations and commercial banks must avoid the temptation of funding medium-term gaps through arrears. Such a temporary and illusory solution can only undermine the reform effort, dissipate market and investor confidence, and replace cooperation with confrontation.

- Finally, no matter how overpowering the debt problem appears in its totality, we must continue to focus our efforts on a case-by-case basis on those elements of the problem which can be solved and then expand on our successes. We must continue to recognize that there are no easy, all encompassing global solutions.

Conclusion

The international community has made significant progress in transforming the strengthened debt strategy from general concepts to practical results in the financing packages that have emerged thus far. While it is still too early to assess the strategy fully, a number of important developments have already occurred:

- The strengthened debt strategy has already renewed resolve in a number of debtor countries to complete the adjustment process. These countries are making significant strides in reforming their economies.

- The strategy is flexible. It can respond to specific country circumstances, whether the debtor is large or small, or close to returning to voluntary lending. It can offer commercial banks a wide range of options to suit their particular needs.

- The agreements in Mexico, the Philippines, and Venezuela indicate that new bank lending and debt reduction can coexist in the same financing packages.

- The reduction in domestic interest rates and capital reflows in Mexico resulting from the bank package are evidence that an important contribution of the strategy may be the restoration of confidence in the debtor country's economy.

- The strategy has the potential to extract debtor countries from the spiral of constantly escalating debt. This not only frees up resources for productive investment, but also boosts optimism in the debtor countries that sustained economic development and improved living standards are still achievable targets not just etherial goals.

- Finally, by combining fundamental economic reform in the debtor countries with substantial debt and debt service reduction by commercial banks, there is now a realistic hope that flows of capital in the form of repatriated flight capital and direct investment will be provided as the "new finance" needed by debtor countries to sustain their recovery. Such a result offers a far more credible solution for long-term growth than a perpetual dependence on new rounds of concerted lending by unwilling commercial banks.

Senator SARBANES. Thank you very much, Mr. Secretary, for your statement and also for the very comprehensive written statement.

I would like to start off.

First of all, you say on page 8 of your written statement:

> The strengthened debt strategy is designed to be flexible and responsive to individual debtor country needs. As a result of the case-by-case approach, the financing packages which emerge from debtor/bank negotiations in the Philippines, Costa Rica, and Venezuela differ markedly from the Mexican package.

Have we put the fear and apprehension of precedent now behind us so that perhaps with some of these smaller countries where the dollar amounts involved are not very large, but the economic difficulty in which they find themselves is very great, that the plan may in fact be more forthcoming to them without the apprehension that it's going to establish some binding precedent when the banks are dealing with a much larger debtor country where they may be unwilling to apply the same approach?

Mr. MULFORD. I think, Mr. Chairman, you should address that question to the panel of bankers.

Senator SARBANES. I think we will when they get here.

Mr. MULFORD. My impression is that the rather negative impression created in the minds of the bankers immediately after the Mexican package was agreed has gradually been dissipated. It's now obvious that there can be widely different approaches to each country's situation.

The different solutions in the Philippines, Costa Rica, and Venezuela have confirmed this. The broad package of options for Venezuela confirms that perhaps it's possible to draw bits and pieces from previous deals that seem to be suitable and put them in a package. Banks can then choose among options without compromising themselves that they have allowed other options to be part of the package.

I think this will go a long way in encouraging the attitude among banks that flexibility—as I put it, not counting the other guy's money all the time—can prevail. As a result, banks will develop and select the options that are of greatest interest to them.

The significance of the Costa Rican deal is that it demonstrates that a small country with a relatively small amount of debt can negotiate a unique solution without it being precedent setting in the minds of the banks for the larger debtors. So I think that's a constructive aspect of the Costa Rican deal.

Senator SARBANES. How long will the Venezuela package take to work out? I see their Finance Minister said he hoped to do it by June or July; is that correct?

Mr. MULFORD. My impression is that they hope to have the terms out into the market within a month or so, and then to tie up the responses, details, documentation and so on so as to sign the deal by midsummer. That I think is their timetable. I think it would be impressive if they can do it in that time.

Senator SARBANES. What comes next?

Mr. MULFORD. First of all, Morocco has been negotiating for some time. There are a couple of outstanding issues between the banks and the Moroccans which have yet to be resolved. They do continue

to meet, and we hope they will make progress and come to some definitive agreement. I can't give you an idea as to timing.

Ecuador has begun negotiations with the banks. I sense that some progress on a preliminary basis is being made.

Uruguay, which had been having conversations with the banks last year, but which then put them to the side as the Presidential election approached, is planning to resume negotiations with the banks relatively soon. In fact I think they may already have had some contact.

Brazil has indicated to us an interest in exploring ideas early on its debt thinking. I have also heard from them that they wish to meet with the banks relatively soon in order to open discussions. I think that is a negotiation which, if the economic program is judged to be credible by the commercial banks, can hopefully begin relatively soon.

Argentina, as I said, is still some ways off.

Senator SARBANES. I see where in Uruguay the new government is trying to push through a major tax reform bill through their legislature and that the IMF has a standby program I take it ready to go assuming they can achieve that tax reform.

Mr. MULFORD. They need to take some steps on the domestic fiscal side to bring their fiscal in balance down a bit, but when we met with the new President of Uruguay a few weeks ago, he was clearly anticipating an early beginning to the discussions with the banks.

I should also note, Mr. Chairman, that other countries that have the prospect of making progress in the relatively near future are Ivory Coast, Nigeria and perhaps Poland. Poland will be meeting with the banks very shortly to discuss its $7–$8 billion of outstanding commercial bank debt.

Senator SARBANES. What creditor countries have been willing to come forward to support the Brady plan?

Mr. MULFORD. Well, Japan in particular has been very constructive and has provided resources in the case of most of the packages thus far. Other countries, surplus countries, such as Germany, have not expressed a willingness to adopt a similar posture. They obviously now have their hands full in their domestic concerns about Eastern Germany.

Other countries that we have approached include Taiwan. Taiwan has been relatively positive, but as yet has not contributed in any marked way to the process, except in the case of Costa Rica.

Senator SARBANES. What other countries would you judge have sufficient economic strength to join in with Japan and hopefully Taiwan to make some contributions?

Mr. MULFORD. I think that most countries would take the view that they are participating in the strategy through their contributions to the international institutions, the IMF and the World Bank, and through the provision of export credit finance and Paris Club rescheduling.

So most countries would take the view that to supplement that with specific resources for debt reduction and debt service reduction is not really necessary. They would take the view that they are supplying resources already through the Fund and the Bank

which are the appropriate places for an agreed consensus based process.

Senator SARBANES. I understand that, but Japan is at least participating in addition to that.

Mr. MULFORD. That's right. They have committed to contribute approximately $10 billion in resources in connection with the plan over a period. They put approximately $2 billion of Eximbank financing resources into Mexico, and they have made other contributions to other country packages.

Senator SARBANES. And Taiwan has played a supplemental role in the case of Costa Rica; is that correct?

Mr. MULFORD. That's correct.

Senator SARBANES. Now who else might play a supplemental role?

Mr. MULFORD. I would say at this point those are the only two practical possibilities.

Senator SARBANES. Because nations are unwilling, and when you say practical, because others are willing to play a role or because others are not financially and economically positioned to play a role?

Mr. MULFORD. I would say in the case of countries with very large surpluses they have been unwilling. In countries where the resources are perhaps less obvious, they have taken the view that they make available their support through the international institutions and will continue to do so.

Senator SARBANES. What is your view of how well the international institutions have worked in trying to address this issue?

Mr. MULFORD. Secretary Brady made his speech on March 10, in the nature of broad ideas. These ideas then were firmed up into more specific proposals within a matter of 3 or 4 weeks, discussed in the IMF and the World Bank, analyzed by their staffs, and acted on by their Boards by the end of May. My personal opinion is that that was a very impressive implementation process of a very complex initiative.

Since then they have been very constructive and helpful in each case in positioning and providing the resources that are needed for debt reduction and interest support arrangements. I would give them very high marks so far for their contribution to the process.

Senator SARBANES. Well, my time is up and I yield to Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

Mr. Chairman, I have some questions that I would call past, present, and future.

First the past questions.

On pages 7 and 8 you do a comparison of the Brady plan with the Baker plan and state that "To complete the assessment, it is necessary to compare these positive results, those that will flow from the Brady plan in Mexico, with the results that would have flowed from the type of all new money solution that characterized the previous debt strategy," and then you do that assessment.

If we had held this hearing 24 months ago, the Treasury would have been saying the same positive and optimistic statement relative to the Baker plan that you are now providing us relative to the Brady plan.

What was it that occurred between 1988 and 1990, what data or what evaluation of the circumstances on the ground that led to the conclusion that continuing with the previous debt strategy would have led to the disastrous consequences detailed on pages 7 and 8?

Mr. MULFORD. I think, Senator, that in the year 1988 after 3 years of experience with the Baker plan, the facts and figures were beginning to come in. There were some patterns that were clearly rather troubling.

One was that the commercial banks were clearly in a process of withdrawing. Each bank would have had its own reasons for doing so, but the pattern was very clear for most banks. They were willing to take write-downs and large provisions, sell debt in the market at deep discounts, and do debt equity swaps at deep discounts. They recognized in general that they were not going to be fully paid out on the debt, and they did not wish to put in additional new moneys.

That was a fundamental development which became, I believe, quite visible during the course of 1988. There were exceptions to that of course, but in general that was the pattern.

Second, it was also clear that as the banks withdrew, the exposure of the international institutions, and to the member governments through those institutions, was rising very sharply. There was implicit in that process a transfer of risk to official institutions, if it had gone on unchecked, it clearly would ultimately have resulted in practically the whole of the stock of debt gradually being shifted to the official side. That was something that we felt was unacceptable.

Third, it was clear by 1988, and I don't think it was clear before that, that there were differentiation in the banking community and attention to markets that made it possible to think in terms of market solutions to some of these problems. There was also the hope that some solution could be found where substantial write-downs could be accomplished without disrupting entirely the potential flow of new money.

In other words, that perhaps debt reduction, if it was accomplished on a voluntary basis, could coexist with the continued provision of new money in some form. Obviously the new money would not be in the form we had seen in the past necessarily, but short-term finance, trade finance, and some medium term finance by so-called new money banks. This new money could coexist with the debt reduction. You will remember that one of the concerns was that debt reduction would effectively kill all new money.

It was clear by late 1988 that that didn't have to be true. It was clear that something could be developed that could take advantage of the willingness of some banks to take losses in a way that would transfer the benefit of those losses through to the debtor country. That essentially is what the Brady plan attempted to do in its construction.

Senator GRAHAM. The present, two issues.

One, there are a number of countries whose indebtedness is primarily to sovereign nations or to international institutions and relatively shallow in terms of commercial bank debt. Jamaica would be one example of that in our hemisphere.

Do you see any corollary of the Brady plan being extended to those nations whose indebtedness is primarily to other than commercial banks?

Mr. MULFORD. Well, the Brady plan primarily addresses the large indebted countries that have heavy commercial bank debt at one end of the spectrum. The so-called Toronto terms that were negotiated at Toronto and at the annual meeting of the World Bank in Berlin the following September addressed the type of situation you've mentioned at the other end of the spectrum, where the countries are very poor, chiefly the poorest countries in Africa that are heavily indebted officially.

In between in the spectrum are countries that have large amounts of official debt but are not as poor as the African countries. You would have Eastern European countries which have heavy official debt, but have relatively high per capita income levels. You have countries that have a mix between commercial bank debt and official debt, but have more official debt than commercial bank debt, and that would be the case, for example, of Jamaica.

It is an extremely difficult task to determine what should be done about the problem that you've mentioned. The official community does provide a great deal of support already through the Paris Club where we have rescheduled principal and rescheduled interest so that we are in fact providing new money as that is defined by the banks. We are keeping our export credit agencies open after Paris Club arrangements have been completed to these countries. We continue to fund the IMF and the World Bank and provide new money through those sources.

So we are still in the new money business. We didn't turn to the debt reduction business for commercial banks until we were pretty sure many banks were no longer in the new money business. Governments are still in it.

Obviously that does not fully address your question. A lot of work has gone on about how to deal with this. Part of it, I might say, Senator, lies here on the Hill. There is a very complex problem in the official debt field, if there were ever to be any reduction of official debt, of how that would be handled in the U.S. budget. The issue arises whether the loss of asset value or future income flows would require an appropriation to cover the shortfall, for example. It's an enormously complex problem.

The short answer is that it would be very unwise to engage in official debt reduction because of the large possibility of contamination. There may be areas where some relief can be generated in the Paris Club. Those will be looked at, and they are being looked at. But in general the feeling at the moment is that official debt reduction on a large scale would be an extremely unwise step.

Senator GRAHAM. One other present issue. Nicaragua has recently voted to adopt a democratic government. We anticipate a peaceful transfer of power and that new government to take place in late April.

That new government will face one of the largest per capita indebtedness in the world owned primarily to its former allies, the Soviet Union and Central Europe.

What will be the attitude of the United States toward the new Nicaraguan Government's responsibility to the indebtedness generated by its predecessor?

Mr. MULFORD. We will take the position that arrearages should be eliminated. Many of the arrearages are to international institutions, which it's critical to clear up in order to reopen those sources of finance.

On the other type of debt that you've mentioned, I think it's too early to see what will happen. Some of the countries that previously provided Nicaragua with funds may well continue to do so, and that issue will be primarily a bilateral issue.

Senator GRAHAM. What is your answer to the question will the United States take a different position vis-a-vis the responsibility of the Nicaraguan Government, the new government to the indebtedness generated by its predecessors than, for instance, it took to the Alfonsin's government responsibility for the indebtedness created by its predecessors?

Mr. MULFORD. I would say in general no, but there could be very special circumstances that could affect that stance. I don't want to say what those are, but I don't want to completely close that door. But in general a new government assumes the liabilities and commitments of the previous government as regards debt. The Alfonsin government certainly did that, and generally speaking you would expect the government to look after its previous obligations.

Senator GRAHAM. Looking to the future, you indicated what had transpired between 1988 and 1989 that led to an assessment that the Baker plan was not going to achieve our objectives, commercial banks withdrawing, the increasing exposure of the international public sector and the ability to achieve debt relief without a total cutoff of new lending.

What are the standards that you are currently monitoring in terms of the success of the Brady plan hopefully to avoid a repetition of riding a horse that won't get us to our destination for 4 or 5 years as we did with the Baker plan?

Mr. MULFORD. Well, there are a number of points to be addressed there, and I will try to just touch on those very briefly.

I should have mentioned in the earlier assessment that we also looked at the issue of policy reform to determine whether in fact real reforms were taking place.

At this juncture I would say that under this strategy the reforms we're seeing are much more genuine, comprehensive, and in-depth. If you take a look at the changes Mexico has made, they are very, very substantial and comprehensive. We will watch the content and credibility of the economic programs very closely.

We will follow very closely the impact of the packages that have been agreed. One of the things we want to assess, which we think is very, very important, is whether the new packages are producing results that encourage a reversal of capital flows.

In other words, we would like to see flight capital, which is a very serious problem, to some extent reversed. We all know that there is an enormous amount of flight capital out there. If these programs are credible, a portion of that may well flow back.

Also, if the reforms are credible and the debt reduction is significant enough, as I've mentioned in Mexico, we think that there will

be a substantial flow of direct private investment. Without capital repatriation and direct investment flows, we don't think this problem is solvable in the long run.

In the case of Mexico, as I said, they've had something like $3 billion of capital inflows and direct investment inflows in 1989. That is a very substantial number. These countries will be financed in the future more heavily by those sources than by a continued dependence on dollops of new commercial bank lending or World Bank and IMF lending, which clearly cannot fully meet their needs.

Finally, we will watch the ratios that you mentioned earlier. In the case of Mexico, for example, we think the various debt ratios that we follow—the debt to GDP ratio, debt to exports, debt service to exports and interest to exports—will make a substantial improvement so that in the years 1990 to 1992 most of those ratios will be at levels that should make Mexico sustainable.

Senator SARBANES. Mr. Secretary, in closing, let me just make a couple observations and maybe a couple of questions.

First of all, you have a conceptual framework for dealing with those countries with large commercial debts, the Baker plan, as you said.

It seems to me your challenge now is to get enough countries who have gone through the plan and are out on the other side and there's been some speculation that Mexico was a very high priority country for the Treasury and now that the Mexico arrangements have been concluded that Treasury will play a less active role with respect to these other countries.

Is there anything to that speculation?

Mr. MULFORD. No, we will not be less active. Perhaps we will be more subtle with the banks and therefore more successful.

Senator SARBANES. Is there any chance that some of these small countries we could anticipate in the next 6 months, Morocco, Ecuador, Uruguay, could go on the list with Chile and Costa Rica and Mexico and the Philippines and Venezuela?

Mr. MULFORD. Personally, Mr. Chairman, although I'm not in the commercial bank negotiations, I don't see why Ecuador, Morocco, and Uruguay could not come to an agreement in principle on a package within the next 6 months. It seems to me that should be feasible.

It seems to me that Brazil has a very strong incentive, as do the banks, to move quickly in their negotiations. The banks now have a great deal of experience under their belts about how to put these packages together. It may well be, because the build-up in arrears has been substantial in Brazil, that it's in everybody's interest to try to get that negotiating process going quickly. Perhaps it's not impossible that an agreement could be worked out in a relatively short period of time. By that I mean between now and the end of the year perhaps.

Senator SARBANES. What about the countries that are being covered by the Toronto terms?

Mr. MULFORD. I don't have exact numbers there, but my memory is that approximately 14 of the 20 countries have already now been rescheduled on greater terms of relief in the Paris Club. A great

deal has already been done for those countries in terms of debt relief, interest relief, and maturity extension.

Senator SARBANES. How many countries does that leave in between the Toronto terms on the one hand and the Brady plan, as you've sort of circumscribed it this morning, on the other, for whom a full conceptual framework has not yet been worked out?

Mr. MULFORD. Well, numbers are hard to pin down. The problem debtor countries are often listed at 39 in number. I think the test for those countries is that they have to have gone through a commercial bank rescheduling, that list wouldn't necessarily include everybody that has a debt problem of some kind.

So I think, Mr. Chairman, I should probably answer that in writing. My guess is that you've got in the middle probably 17 or 18 countries between the Baker 15 or 16 and the countries of Africa. You probably have 17 or 18 countries in the middle that have problems of one kind or another, which would include Poland. It would include Jamaica, the Dominican Republic and so on. I can send you a list.

Senator SARBANES. I think it would be helpful for us to have it.

One of the things I think in a subsequent probably oversight hearing we're going to have to look at is how well the premises are holding up for the countries that have been through the plan. As I see it, we've got three problems here. One is moving all the countries through the plan, whether it's the Brady or the Toronto plan. Some have been moved through it. Others have not. Of course, for the ones who have not, they're still in the position of despair, so to speak. They haven't been put on a track that people hope will enable them to work out their economic circumstances.

The second is to work out the concepts for the countries in between where there's not as yet clear framework.

Then the third is after you move all these countries through their respective plans, then how do the plans hold up in the light of economic developments? How well founded were the premises? Have they in fact been able to get them back on a path of growth or was it not enough or not done the right way or did economic circumstances change to such a degree that expectations did not prove themselves out?

I'd like to get these countries through the plan so we can focus on this last thing because until you move them through a plan the countries are not on any sort of path that they can present to their people as one that offers a prospect of prosperity.

Mr. MULFORD. Well, Mr. Chairman, the Brady plan is a broader-based plan than its predecessor because it was not limited to 15 countries. It has a broad applicability. For example Jamaica, which is not one of the 15 heavily indebted countries under the Baker plan, does have commercial bank debt. They are negotiating. I don't know whether the bankers can confirm that, but there's certainly been some progress there. I believe a Canadian bank has the lead on Jamaica.

It just so happens that the balance of their debt is such that their entire problem cannot be addressed just by commercial bank negotiations.

But Jamaica has access to the Paris Club and other official sources of finance. I think your suggestion is a very good one. We

need to assess every country's chances, but the key is that the country needs to have a credible economic reform program that really does lay the basis for sound economic development.

Too often in the past, countries only did enough to get the next phase of commercial bank lending. Now they face a situation of a one-time treatment by the banks in a negotiation. The incentives for them to have a credible program that will be sustainable are far greater. And this is already showing up in the programs that we are seeing. It is not showing up in every country, but it is showing up in many of the major countries. Obviously, in the case of Brazil, the announcements made so far show a quite different approach to economic policies, if they can implement what they have announced.

That's also been the picture in Venezuela. It's been the picture in Mexico. Costa Rica has done a good job but has a little more to do to mend its IMF program before it can actually complete the bank deal that's been agreed. That will have to be done in order to ensure their sustainability.

Senator SARBANES. Senator Graham, do you have anything further?

Senator GRAHAM. Mr. Chairman, I continue to be concerned that we not allow another period of drift as we had in the late 1980's to occur.

As I look at Mr. Mulford's statement, he states, "My own sense is that many debtor countries and commercial banks have been coming to terms with the new reality." I am pleased with that. I would also hope that we would add a third, and that is that the U.S. Government would be coming to grips with the new reality and the new reality is that we have paid a tremendous price in terms of our own domestic economy and our future economic and political relationships with this hemisphere. Events of the recent past, I believe, have made our relationships in this hemisphere even more strategically important to the United States at the very time that we have adopted policies that have contributed to the ripping of that relationship.

I would also like to point out that these are countries which have had periods in the recent past of significant economic growth. There was a time in the 1960's and 1970's when the Central American countries were some of the fastest growing countries in the world in terms of their annual GNP growth. I have read an economic survey that says that from 1930 until 1980 Mexico had an annual GNP growth that was essentially the equivalent of the United States during that same 50-year period. So there are fundamental strengths in these countries which have been largely suppressed by this massive external debt that was accumulated in the late 1970's and early 1980's and which continues to submerge their ability to meet the needs of their people.

The newspaper article I cited earlier from the Los Angeles Times indicated that Mexico needs approximately a 6-percent annual GNP growth in order to sustain its demographic growth. Basically, the same figure is required for Brazil and other important countries in Latin America.

The report that you submitted indicates that Mexico has improved its GNP from 1.1 percent in 1988 to 2.5 percent in 1989, but

that's less than half of what's required in order to have a level of economic expansion to meet population and economic needs.

So I conclude with the same statement of skepticism that I began. I am personally going to be closely monitoring the data. I hope that it will overcome my skepticism and we will have a fiesta and a celebration of success, but I hope even more that we will avoid a fantasy-land hope that process will overcome substance and that this problem will go away because we will it to do so.

The cost of that has already been enormous and the cost in the future will be even more so.

Mr. MULFORD. May I please address these questions and perhaps offer some help to remove your skepticism?

First of all, let me make some general points. In the years since the debt problem came upon us, we have had one major accomplishment which is not recognized in your statement. We have avoided a world financial catastrophe. This was a systemic problem when it arrived in 1982 and it remained a systemic problem for a number of years.

Today, I think we can say that it is perhaps not a systemic problem. That is a substantial accomplishment. We have avoided the kind of financial dislocation which was entirely possible at any moment during the height of this crisis.

Second, our banks are stronger than they were. They were greatly weakened at earlier abuses of the process. All of us want a strong banking system. The banks have had time to strengthen their balance sheets, readjust their portfolios, and now they are cooperating in this strategy from a position of strength. That makes them harder to deal with sometimes, but it's a better situation to be in.

Third, the growth that you mentioned in the past, particularly in the late 1970's, was impressive but it was financed by heavy liquidity and it was highly inflationary. It was not permanently achieved growth. It was in a sense illusory. We are now hoping to go for solutions that produce sounder, low-inflationary growth in Latin America.

And finally, on the question of trade, I will send you trade figures which will show that in the Latin American debtor countries United States trade is recovering. We are not back all the way in every case. We would like to have stronger markets, but we have passed the trough of greatest damage and see our trade recovering, particularly in Mexico where the results have been dramatic.

Finally, I would like to say that I don't think the administration is adrift and certainly the Treasury is not adrift. Any commercial banker you talk to or debtor country would certainly not agree that we're adrift. The Treasury has been more aggressive, in recent years than was true before and we have often been criticized for it. We are providing leadership and close attention to this problem in order to accomplish just the things that you wish us to accomplish.

Senator SARBANES. Mr. Secretary, let me just say to that, I think you may in fact be correct that there is no longer a systemic problem with respect to financial dislocation. But from the point of view of economic growth for the debtor countries, I don't think we can yet say that. I think there's still a large question mark over whether enough has been done or will be done so that there is no

longer a systemic problem on the economic growth issue. I think that continues to remain a very large challenge and, of course, as Senator Graham has pointed out, the economic growth issue of these debtor countries is very much related to the U.S. trade position with these debtor countries since so many of them are in our hemisphere and have traditionally been very important and significant trading partners for us.

So I think part of the systemic problem may no longer be systemic, but I don't know that the balance of it is yet there and, therefore, we urge you on and I appreciate the assurances this morning that the Treasury is going to stay very deeply involved in this matter with an increased degree of subtlety as it proceeds.

Mr. MULFORD. I agree with your assessment. My remarks about the systemic problem were with regard to the international financial system which would have been a very serious problem had it materialized. But obviously, we are very concerned about the situations in the debtor countries, their ability to restore sustained growth, the maintenance of democracy, improvements in their economic well-being, as well as our own economic well-being in this country, given the importance of access to markets.

So I agree with your assessment. There is a lot to be done. That part of the problem is not behind us.

Senator SARBANES. Very good. Thank you very much for your testimony this morning.

We will now turn to the panel of three representatives from the major commercial banks, Mr. Rhodes from Citibank; Rod Wagner from Morgan Guaranty Trust Co.; and Peter McPherson from the Bank of America.

Gentlemen, unless you have worked out an order amongst yourselves that you think makes sense, I'll probably start with Mr. Rhodes and we'll just go straight across the panel.

## STATEMENT OF WILLIAM R. RHODES, SENIOR EXECUTIVE-INTERNATIONAL, CITIBANK N.A., NEW YORK, NY

Mr. RHODES. Thank you, Mr. Chairman.

My name is William R. Rhodes. I am senior executive international at Citibank. I was principal cochairman of the bank advisory committee for Mexico during the negotiations that led to the current agreement between Mexico and its commercial bank creditors worldwide.

I have also chaired the bank advisory committees for Brazil, Argentina, Peru, and Uruguay.

Since last March, there have been fundamental changes in the official debt strategy. The effects of these changes, however, still are far from clear. The strategy that had been followed since August 1982, when the debt crisis began until last March, focused on new money as the cornerstone of the financial packages that commercial banks assembled for various restructuring countries.

The goal was to provide the countries with both time and resources by postponing debt repayments and encouraging new money—while they made necessary economic reforms.

Progress was made under this new money oriented strategy. With support from commercial banks and other creditors, many of

the restructuring countries started reforming, privatizing and opening their economies. Chile, Uruguay, Mexico, and the Philippines, all of which have returned to growth, are cases where the right economic policies are working.

Some of the countries, however, have so far failed to make meaningful economic reforms and progress overall has been slower than many of us had hoped for.

Last March, Secretary Brady proposed that voluntary debt reduction by the commercial banks replace new money as the centerpiece of a changed strategy. He also made the point, largely overlooked since, that some continuing flows of new money must remain an essential part of that strategy. He continued to stress the need for continuing economic reforms by the borrower countries. Commercial banks have negotiated preliminary agreements on four packages under the revised strategy—with Mexico, the Philippines, Costa Rica, and now Venezuela.

Last month, at the invitation of Mexico's President, Carlos Salinas de Gortariz, creditor banks began signing the first of these packages in Mexico City. The Philippines completed its debt buyback in January and started signing its new money facility in Tokyo late last month. Costa Rica has obtained the needed waivers from its creditor banks and its package is now in the market.

Just yesterday, the Government of Venezuela and its bank advisory committee announced the completion of a preliminary agreement on an innovative financial package. This package includes a menu of options that should give the country significant debt reduction along with the new money needed to support its economic reform program.

Negotiations are now underway with several other countries. In addition, Brazil's new President, Fernando Collor de Mello, introduced last Friday a bold and innovative economic program that is without precedent in that country's history in both detail and scope. We expect to hear from Mr. Collor's representative shortly as to when they will meet with Brazil's bank advisory committee.

The Mexican package is the first during the debt crisis to emphasize voluntary debt reduction more than new money. Yet it combines the two in a way that the Government of Mexico believes will allow the country to put the debt crisis behind it, create a base for investment and enter a period of sustained economic growth.

Given continued progress with the Government's economic reform program, I think Mexico can accomplish this.

The response from the international banking community has been unprecedented for any package of this size and magnitude. As of late yesterday, 465 of Mexico's approximately 470 banks had signed the agreements. This represents over 99.9 percent of the total exposure. By the time we close the books and issue the debt reduction bonds a week from today, all may be in. In effect, there may be no free riders at all.

The financial package covers all of Mexico's $48.5 billion in medium- and long-term debt to commercial banks. Banks representing 41 percent of the debt chose to reduce principal at a discount of 35 percent and banks representing 49 percent chose to reduce debt service by limiting interest payments to a fixed 6.25

percent. The remaining banks, representing approximately 10 percent of the debt, will lend new money.

The importance of the debt service reduction bonds is oftentimes underestimated. By decreasing Mexico's payments and setting a fixed rate, they give the country, in effect, a 30-year shield against rising interest rates, which, you will remember, were a major cause of the debt crisis, particularly in the case of Mexico, in the first place.

As we have seen, the debt reduction instruments account for approximately 90 percent of the agreement and debt principal reduction is twice as much as initially forecast. Even more important, the package is a demonstration of confidence in Mexico and a recognition of its historic economic reform program by its various creditors—governments, the multilateral organizations, and commercial banks. This demonstration of support should help the country further reduce the cost of servicing its very large internal debt and attract new investment from both domestic and foreign sources.

Since our negotiations began last spring, internal interest rates within Mexico have dropped, flight capital has been returning, and there have been increased signs of new investment inflows. Economic growth reached approximately 3 percent in 1989, the highest since 1982.

I think it all boils down to regaining confidence, which is what Mexico needs to move ahead.

I was first quoted last July saying that the Mexican package is no cookie cutter. The package for Mexico is responsive to the circumstances in Mexico, which differ from the circumstances in other countries. As an example, compared to the three basic options in the Mexican agreement, the Philippine agreement just has two options—the debt buyback and new money.

As we look ahead, I have several major concerns over the changed strategy, all of them closely related. One is the fact that the resources made available by the public sector to support debt reduction are proving insufficient to meet the expectations raised in many countries by the Brady plan. In this respect, it would be helpful if other surplus industrialized countries would follow the leadership of Japan and establish recycling programs. In addition, government export development agencies should restore their lines of credit more rapidly to countries making progress in economic reform.

Through the Paris Club, creditor governments should lengthen their restructurings and grace periods and lower interest rates, much as the commercial banks have been doing. In a few recent cases, I am happy to say, the Paris Club has shown more willingness to do this than in the past.

I have several specific recommendations, however, on modifications to the Brady plan that I hope the IMF interim committee will consider when it meets here in early May. These recommendations, if adopted, would facilitate progress in debt reduction packages still to be negotiated for such countries as Brazil and Argentina and speed up the process, which I think we all agree needs to be speeded up.

First, the multilateral institutions could further help the restructuring countries by allowing them more flexibility with the resources that are currently allocated specifically to each type of debt reduction, whether a cash buyback or instruments to reduce debt principal or debt service.

The fungibility, or as I refer to it, commingling of these resources would enable each country to use the funds to its maximum benefit for the debt reduction techniques most appropriate to its particular needs.

Second, countries like Colombia, which has not restructured its debt, should be leading candidates to benefit from the World Bank's new Expanded Co-financing Operation nick-named ECO. At the same time, I hope that the World Bank will consider extending that program to countries that are successfully coming out of the restructuring process, have met their obligations, and are following viable economic programs. Chile, Mexico, Uruguay, and the Philippines come immediately to mind.

Third, one of the lessons we learned from the Mexican package is the importance of up-front enhancements. The international financial institutions could help the indebted countries speed their negotiations with commercial banks by being more flexible in up-fronting these enhancements. A group of commercial banks recently completed a $1.2 billion bridging to the enhancements for Mexico only with great difficulty and after long negotiations.

Fourth, the World Bank could facilitate the countries' negotiations with their commercial banks by being more forthcoming in granting waivers to its negative pledge clause. This would permit a greater variety of financing techniques specifically designed to the countries needs to help them get back to the voluntary markets.

Another concern that I have is the almost exclusive emphasis being placed in practice on voluntary debt reduction over some continuing flows of new money. In the first three packages negotiated under the changed strategy, excepting yesterday's Venezuelan agreement, all the enhancements are devoted to encouraging debt reduction. Many banks feel that this signal—and others that they have been receiving from some public officials—stress debt reduction only, not new money; and they are responding accordingly.

Mexico and the Philippines needed incremental new money from commercial banks to help finance the debt reduction options in their packages. Yet both countries had difficulty raising new money. Other countries, including some less successful at economic reform, could face a similar problem in future negotiations.

Of more fundamental concern, many developing countries will continue to need some new commercial bank funding over the longer term, as they have in the past, to complement their own savings, foreign investment inflows, and funds from official sources. Yet debt reduction programs, particularly those involving debt principal reduction, basically encourage banks in many cases to end their lending relationship with the participating countries. It is appropriate that some banks, consistent with their business strategies, choose to go this route. It is also appropriate that such banks do so through burden-sharing by voluntarily taking losses through debt reduction programs.

These programs, unlike discounted sales to third parties in the secondary market, pass on the benefit of those losses to the countries directly themselves. At the same time, I believe there is a core group of international lenders—I would count my own institution there—that have a commitment to future lending in Latin America. These banks would be willing under the right circumstances to continue to support with new money, where needed, those countries that are making serious efforts to reform their economies and need financing for their ongoing development programs.

Consequently, commercial bank financing packages should be designed not only to provide exit instruments for banks wishing to leave but also to encourage a core group of banks to continue lending to the developing world. If this does not happen, many developing countries will have to rely exclusively on their own internal savings and capital flows from official sources.

Recent history suggests that this dependence could severely limit the growth of a number of these countries in the developing world. Specifically, I support a more balanced financing approach for future commercial bank packages, one that in addition to voluntary debt reduction recognizes the importance of some continuing new money flows. New money options that have proven successful in earlier packages include trade finance facilities, on-lending, project financing, new money bonds, debt-equity conversions and cofinancings with the World Bank and perhaps with regional development banks such as the Inter-American Development Bank. In the latter case, I understand that President Enrique Iglesias of the Inter-American Development Bank is looking at such additional programs.

With the exception of cofinancing, all of these new money options are negotiated solely between the restructuring country and its creditor banks. Unlike enhancements for debt reduction, they do not involve public funds.

On a hopeful note, there have been indications recently that some policy-makers are beginning to see that debt reduction alone cannot solve the debt problem for all countries and that some new money flows from a core group of international banks are essential.

Also, in yesterday's Venezuelan agreement, the new money is enhanced with provisions to convert 30 percent into equity at par, as an example of what I'm talking about on enhancements. I am further concerned over significant increases in arrearages in interest payments to commercial banks by a number of countries since the adoption of the current strategy. In some cases, this development may reflect a perception by those countries that the current strategy condones their use of arrearages as a form of external financing. The international financial institutions, for example, in some cases, have broken with previous policy and disbursed funds to countries that are in arrears to commercial bank creditors. I think that the international financial institutions, however, are beginning to see that arrearages to commercial banks can also stimulate arrearages to them.

Of the countries that have negotiated debt reduction agreements under the changed strategy, Mexico and the Philippines were fully current on interest. Costa Rica, although in arrears, was making regular partial payments. The Costa Ricans agreed as part of their

commercial bank package to clear arrearages through a 20-percent downpayment, a repayment schedule without grace period, and a rolling 3-year interest guarantee on past-due interest. This part of the agreement with Costa Rica, I think, demonstrates the importance that the banks place on resolving pending interest arrearage problems.

As part of its announcement yesterday, the Government of Venezuela said it will bring its interest current by the end of March.

I believe that continuing arrearages will make it increasingly difficult to complete future commercial bank financing packages for the countries in question and therefore will retard their programs of economic growth and reform. I believe that a combination of voluntary debt reduction and some new money, in those cases where it's needed, is the most promising way out of the crisis. This formula can be successful only if accompanied by demonstrated progress by the countries in reforming and opening their economies and encouraging local savings and direct investment.

Today, this latter point is particularly important, with the strong demand for capital worldwide intensified now, due to the opening of Eastern Europe. Mexico comes to mind immediately, since we are working closely with them to complete our agreement, as a country that has accepted, and is answering, that challenge.

Given the problems and uncertainties that I have outlined, I believe that the current strategy has positioned the debt crisis at a turning point.

If not managed carefully, the strategy could undermine the progress to date and leave future external financing for much of the developing world entirely to governmental sources. If managed carefully, however, with a renewed emphasis on cooperation among all parties—and cooperation is crucial--it could alleviate the situation and set the stage for the eventual return of some of the restructuring countries to the private capital markets.

[The complete prepared statement of William R. Rhodes follows:]

STATEMENT OF

WILLIAM R. RHODES

SENIOR EXECUTIVE - INTERNATIONAL

CITICORP/CITIBANK

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE AND

MONETARY POLICY

OF THE

COMMITTEE ON BANKING, HOUSING

AND URBAN AFFAIRS

UNITED STATES SENATE

WASHINGTON

MARCH 21, 1990

My name is William R. Rhodes. I am Senior Executive - International at Citicorp/Citibank, responsible for the cross-border portfolio and international-debt negotiations. I was principal co-chairman of the Bank Advisory Committee for Mexico during the negotiations that led to the current agreement between Mexico and its commercial-bank creditors worldwide. Since 1982, I have also chaired the Bank Advisory Committees for Brazil, Argentina, Peru and Uruguay. Accompanying me today is Jack Guenther, Citibank's senior international economist.

I would like to thank you for this opportunity to present my thoughts on the international debt situation and to offer some

specific recommendations on how to strengthen the current strategy.

When I last testified at a Congressional hearing, a year ago last January, before the House Committee on Banking, Finance and Urban Affairs, I suggested that the debt crisis was entering a new phase -- one centering on voluntary debt reduction, but still requiring some continuing flows of new bank lending, where needed. Since then, there have indeed been fundamental changes in the official debt strategy. The effects of those changes, however, still are far from clear.

The strategy that had been followed since August 1982, when the debt crisis began, until last March, focused on new money as the cornerstone of the financial packages that commercial banks assembled for various restructuring countries. The emphasis was on burden-sharing and cooperation among the various parties -- creditor and debtor governments, the international financial institutions and the commercial banks.

The common goal was to provide the countries with both time and resources -- by postponing debt repayments and encouraging new money -- while they made necessary economic reforms. These reforms, in time, would allow the countries to return to the voluntary capital markets, where they could again raise the incremental funds that they will need, as developing countries, for their future growth.

New-money agreements, which encouraged large numbers of creditor banks to continue lending to the countries, clearly were consistent with that goal.

At the same time, voluntary debt-reduction programs were introduced, in 1984, and they grew in importance. In 1988, for the first time since the debt crisis began, the countries of Latin America, as a group, managed to reduce their external debt.

An indebted country gains from debt reduction to the extent that it reduces its total debt or its interest cost. However, the country takes the longer-term risk of limiting its future financing: Banks that have taken losses on loans to a borrower are less likely to lend again soon to the same borrower.

Progress was made under this new-money-oriented strategy. With support from commercial banks and other creditors, many of the restructuring countries started reforming, privatizing and opening their economies. Chile, Uruguay, Mexico and the Philippines, all of which have returned to growth, are cases where the right economic policies are working. As an example, during the second half of the 1980s, growth averaged 6.6 percent a year in Chile and 4.9 percent in Colombia, while in Mexico it has now reached 3 percent. There have also been a few, though small, voluntary market transactions, by Chile, Mexico, Uruguay and Venezuela.

Some of the countries, however, have so far failed to make meaningful economic reforms, and progress overall has been slower than many of us had hoped. Last March, Secretary Brady proposed

that voluntary debt reduction, by the commercial banks, replace new money as the centerpiece of a changed strategy. He also made the point, largely overlooked since, that some continuing flows of new money must remain an essential part of that strategy.

In response to the Brady proposals, the International Monetary Fund and the World Bank agreed to make available certain resources, to back debt-reduction programs, for countries that have viable economic programs. Commercial banks have negotiated preliminary agreements on three packages under the revised strategy -- with Mexico, the Philippines and Costa Rica. Last month, at the invitation of Mexico's President, Carlos Salinas de Gortari, creditor banks started signing the first of the three packages at a ceremony in Mexico City. The Philippines completed its debt buy-back in January and started signing its new-money facility in Tokyo late last month. Costa Rica has obtained the needed waivers from its creditor banks and its package is now in the market.

Negotiations are underway with several other countries, the most prominent of which is Venezuela. The Government of Venezuela and its Bank Advisory Committee expect to announce momentarily the completion of a preliminary agreement on an innovative financial package. This package will include a menu of options that should give the country significant debt reduction along with the new money needed to support its economic reform program. Another borrower country, Morocco, is resuming talks with its Bank Advisory Committee in Paris this week. In

addition, the new Government of Uruguay has informed Citibank, as chairman of its bank committee, that it expects to resume negotiations within the next 30 days.

The Mexican package -- the most complex and innovative ever assembled in the international markets -- is the first during the debt crisis to emphasize voluntary debt reduction more than new money. Yet it combines the two in a way that, the Government of Mexico believes, will allow the country to put the debt crisis behind it, create a base for investment and enter a period of sustained economic growth. Given continued progress with the Government's economic-reform program, I think Mexico can accomplish this. At a breakfast I attended last month in Mexico City, President Salinas reiterated his commitment to open the economy, privatize, deregulate and maintain order in public finances by reducing the deficit as a percentage of GDP.

The response from the international banking community has been unprecedented for any package of this magnitude. As of Monday, March 19, 465 of Mexico's approximately 470 creditor banks had signed the agreements. By the time we close the books, and issue the debt-reduction bonds, a week from today, all may be in. There may, in fact, be no free-riders.

In addition, two weeks ago, the Government of Mexico and 35 major international banks signed a $1.2-billion letter-of-credit facility that will allow the country to have in place, when we issue the bonds next week, the entire $7 billion in debt-

reduction enhancements. I will refer to this facility later when I discuss the importance of "up-fronting" enhancements.

The financial package covers all of Mexico's $48.5 billion in medium- and long-term debt to commercial banks. Banks representing 41 percent of the debt chose to reduce principal, at a discount of 35 percent; and banks representing 49 percent chose to reduce debt service by limiting interest payments to a fixed 6-1/4 percent. The remaining banks, representing 10 percent of the debt, will lend new money. If the foreign offices of Mexican banks are included in the figures, new money is approximately 13 percent of the total debt.

The importance of the debt-service-reduction bonds is sometimes underestimated. By decreasing Mexico's payments and setting a fixed rate, they give the country a 30-year shield against rising interest rates, which were a major cause of the debt crisis in the first place.

When we announced the agreement in principle last July, it was criticized by some academics and the press for containing too little debt reduction, not enough discount and too much new money. However, as we have seen, the debt-reduction instruments account for approximately 90 percent of the agreement, and debt-principal reduction is twice as much as initially forecast.

Even more important, the package is a demonstration of confidence in Mexico, and recognition of its historic economic-reform program, by its various creditors -- governments, the multilateral organizations and commercial banks.

This demonstration of support should help the country further reduce the cost of servicing its very large internal debt and attract new investment from domestic and foreign sources. Since our negotiations began last spring, internal interest rates within Mexico have dropped, flight capital has been returning and there have been increased signs of new investment inflows. Economic growth reached 3 percent in 1989, the highest since 1982. It all boils down to regaining confidence.

I was first quoted last July saying that the Mexican agreement is no cookie-cutter. The package for Mexico is responsive to circumstances in Mexico, which differ from circumstances in other countries. For example, compared to the three basic options in the Mexican agreement, the Philippines agreement has just two options -- a debt buy-back and new money -- while the Costa Rican agreement has no new-money option. Some other countries may need only one debt-reduction choice. Some will need new money, others won't.

Given the different circumstances of each country, I expect that the case-by-case, or country-by-country approach, which has been followed since the crisis began, will continue.

As we look ahead, however, I have several major concerns over the changed strategy, all of them closely related.

One is the fact that the resources made available by the public sector to support debt reduction are proving insufficient to meet the expectations raised by the Brady Plan.

In this respect, it would be helpful if other surplus industrialized countries would follow the leadership of Japan and establish recycling programs. In addition, government export-development agencies should restore their lines of credit more rapidly to countries making progress in economic reform.

Through the Paris Club, creditor governments should lengthen their restructurings and grace periods and lower interest payments, much as the commercial banks have been doing. In a few recent cases, the Paris Club has showed more willingness to do this than previously.

I have several specific recommendations, on modifications to the Brady Plan, that I hope the IMF interim committee will consider when it meets here in early May. These recommendations, if adopted, would facilitate progress in debt-reduction packages still to be negotiated for such countries as Brazil and Argentina.

First, the multilateral institutions could further help the restructuring countries by allowing them more flexibility with the resources that currently must be allocated specifically to each type of debt reduction, whether a cash buy-back or instruments to reduce debt principal or debt service. The fungibility, or as I refer to it, co-mingling, of these resources would enable each country to use the funds to its maximum benefit, for the debt-reduction techniques most appropriate to its particular needs.

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Second, countries like Colombia, which has not restructured its debt, should be leading candidates to benefit from the World Bank's new Expanded Cofinancing Operation (ECO). At the same time, I hope that the World Bank will consider extending that program to countries that are successfully coming out of the restructuring process, have met their obligations and are following viable economic programs. Chile, Mexico, Uruguay and the Philippines come to mind.

Third, one of the lessons we learned from the Mexican package is the importance of up-front enhancements. Some of the funds from the international financial institutions are not made available immediately; rather, they are phased in over a period of time. The international financial institutions could help the indebted countries speed their negotiations with commercial banks by being more flexible in up-fronting these enhancements. A group of commercial banks completed the $1.2-billion bridging for Mexico, which I referred to earlier, only with great difficulty and after long negotiations.

Fourth, the World Bank could facilitate the countries' negotiations with their commercial banks by being more forthcoming in granting waivers to its negative-pledge clause. This would permit a greater variety of financing techniques specifically designed to the countries' needs.

Another concern that I have is the almost exclusive emphasis being placed, in practice, on voluntary debt reduction over continuing flows of new money. In the three packages negotiated

under the changed strategy, all the enhancements are devoted to encouraging debt reduction.

Many banks feel that this signal, and others that they have been receiving from some public officials, stress debt reduction only, not new money, and they are responding accordingly. Both Mexico and the Philippines needed incremental new money from commercial banks to help finance the debt-reduction options in their packages. Yet both countries have had difficulty raising new money. Other countries, including some less successful at economic reform, could face a similar problem in future negotiations.

Of more fundamental concern, many developing countries will continue to need some new commercial-bank funding over the longer term, as they have in the past, to complement their own savings, foreign investment inflows and funds from official sources.

Yet debt-reduction programs -- particularly those involving debt-principal reduction -- basically encourage banks to end their lending relationships with the participating countries. It is appropriate that some banks, consistent with their business strategies, choose to go this route. It is also appropriate that such banks do so through burden-sharing, by voluntarily taking losses through debt-reduction programs. These programs, unlike discounted sales to third parties in the secondary market, pass on the benefits of those losses to the countries themselves.

At the same time, I believe that there is a core group of international lenders, my own institution included, that have a

commitment to the future of Latin America. These banks would be willing, under the right circumstances, to continue to support, with new money where needed, those countries that are making serious efforts to reform their economies.

Consequently, commercial-bank financing packages should be designed not only to provide exit instruments for banks wishing to leave, but also to encourage a core group of banks to continue lending to the developing world. If this does not happen, many developing countries will have to rely exclusively on their own internal savings and capital flows from official sources. Recent history suggests that this dependence could severely limit the growth of the developing world.

Specifically, I support a more balanced financing approach for future commercial-bank packages -- one that, in addition to voluntary debt reduction, recognizes the importance of some continuing new-money flows. New-money options that have proven successful in earlier packages include trade-finance facilities, onlending, project financings, new-money bonds, debt-equity conversions and co-financings with the World Bank, and perhaps with regional development banks, such as the Inter-American Development Bank.

With the exception of co-financings, all of these new-money options are negotiated solely between the restructuring country and its creditor banks. Unlike enhancements for debt reduction, they do not involve public funds.

On a hopeful note, there have been indications recently that some policy-makers are beginning to see that debt reduction alone cannot solve the debt problem and that some new-money flows, from a core group of international banks, are essential.

I am further concerned over significant increases in arrearages in interest payments to commercial banks by a number of countries since the adoption of the current strategy. In some cases, this development may reflect a perception by those countries that the current strategy condones their use of arrearages as a form of external financing. The international financial institutions, for example, in some cases have broken with previous policy and disbursed funds to countries that are in arrears to commercial-bank creditors. I think that the international financial institutions are beginning to see, however, that arrearages to commercial banks can also stimulate arrearages to them.

The arrearage problem, if not addressed satisfactorily, will have important ramifications for both creditor banks and indebted countries. Last year many creditors increased their loan-loss reserves, significantly reducing earnings. Some of them cited mounting arrearages as a major reason.

Of the three countries that have negotiated debt-reduction agreements under the changed strategy, Mexico and the Philippines were fully current on interest, and Costa Rica, though in arrears, was making regular partial payments. The Costa Ricans agreed, as part of their commercial-bank package, to clear

arrearages through a 20 percent downpayment, a repayment schedule without grace period and a rolling three-year interest guarantee on past-due interest. This part of the agreement with Costa Rica demonstrates the importance that banks place on resolving pending interest-arrearage problems.

Continuing arrearages will make it increasingly difficult to complete future commercial-bank financing packages for the countries in question and therefore will retard their programs of economic growth and reform.

As I said in my Congressional testimony of January 1989, I believe that the combination of voluntary debt reduction and some new money, where needed, is the most promising way out of the debt crisis. This formula can be successful only if accompanied by demonstrated progress by the countries in reforming and opening their economies and encouraging local savings and direct investment.

Today this latter point is particularly important, with the strong demand for capital worldwide intensified now, due to the opening of Eastern Europe. Mexico comes to mind immediately, since we are working closely with them to complete our agreement, as a country that has accepted, and is answering, that challenge.

Given the problems and uncertainties that I have outlined, I believe that the current strategy has positioned the debt crisis at a turning point.

If not managed carefully, the strategy could undermine the progress to date and leave future external financing for much of

the developing world entirely to governmental sources. If managed carefully, however, with a renewed emphasis on cooperation among all parties -- and cooperation is crucial -- it could alleviate the situation and set the stage for the eventual return of some of the restructuring countries to the private capital markets.

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Senator SARBANES. Thank you very much, Mr. Rhodes.
Mr. Wagner.

**STATEMENT OF RODNEY B. WAGNER, VICE CHAIRMAN—CREDIT POLICY, MORGAN GUARANTY TRUST CO. OF NEW YORK, NEW YORK, NY**

Mr. WAGNER. Thank you, Mr. Chairman.

Mr. Chairman, Senators, I thought I would take a few minutes this morning to comment on how the LDC debt problem has evolved and where we are today. As with so much else in the world, change is at work, and the world of LDC debt has changed greatly in the 1980's.

In 1982 when Mexico announced their serious debt crisis, banks were shocked and frightened. Many were frightened for their own survival and that the entire financial system could be badly damaged or even collapse. There was a belief by many that the countries in trouble were facing a short-term liquidity problem, and if sufficient amounts of cash could be provided, then the countries in trouble could pull through and we would survive.

The banks, grouped together partly by fear, cooperated with each other to work out new money for the countries in trouble. There was good cooperation with the World Bank, IMF, Paris Club, IABD and others.

Today, 1990, the situation has changed.

The banks are in a very different situation. In the last 8 years, provisions have been increased either voluntarily or, in some countries, by regulatory requirement. Balance sheets are much stronger today and few banks are threatened with collapse by the LDC issue.

The financial system as a whole is no longer threatened with possible collapse by the LDC problem. As banks have strengthened themselves, the system has been strengthened.

Also, the perception of the problem has evolved. It is now recognized that we are facing a problem of structural reform, not one of short-term liquidity. Increasingly, the countries are looking at themselves and developing a better understanding of the need for change: whether it is opening up the economy to allow more competition; reducing the cost and distortion of subsidies; overhauling tax systems, and on and on. With this change in perception has come an increased awareness that this process takes time.

Also, there have been disappointments in the failure of some countries to undertake structural reform. This has led to quite a few countries falling behind in paying interest on loans owed to the banks and in some cases, to the World Bank and IMF. These arrears in interest payments have upset many banks in the United States, Europe, and Japan and led them to re-assess their long-term involvement in these countries.

Finally, the secondary market for LDC debt has expanded greatly in the last several years. This has provided a way for banks over time to sell or swap their loans to reduce their loan portfolio. Today banks have a way to dispose of their debt if they wish, though often at a high cost to the bank.

These developments—stronger bank balance sheets, the financial system no longer at risk; the problem being a longer-term restructuring one rather than a short-term liquidity problem; failure to undertake structural reform and increased interest arrears; and expansion of the secondary market in LDC debt—have caused banks to go in their own directions. The international banking community is no longer bound together by fear, but instead is pursuing what each bank believes is best for its future.

We believe the Brady plan anticipated these developments and realized that banks were increasingly going their own way and that little new money would be forthcoming. The lesser developed countries have continued to have an ongoing need for resources and little new money from banks is available. The Treasury understood this and searched for an alternative. They focused on reducing cash outflow. This they attempted to achieve by introducing enhancements to induce banks to reduce the amount of the loans to LDC's or to reduce the interest being paid. In this way, the LDC will pay less out and thus be able to have funds needed for development.

When introduced in March 1989, this was a new and complex idea that was not fully defined, and in some countries, expectations ran well ahead of reality. In spite of these early problems, complex transactions have been completed in Mexico and the Philippines; negotiations with Costa Rica are done and we have just completed negotiations with Venezuela. I believe the Brady plan is working. We do have problems. What the enhancements can be used for [interest or principal?]; when they are made available; and a shortage of enhancements—Japan is the only country that has joined with the World Bank and IMF in making enhancements available.

For the future, I believe we will see more ways in which to reduce debt or interest payments. The Brady plan's enhancements are a good start, but as time passes, bankers and the debtor countries will devise ways to use enhancements more effectively.

[The complete prepared statement of Rodney B. Wagner follows:]

TESTIMONY BY RODNEY B. WAGNER

VICE CHAIRMAN CREDIT POLICY COMMITTEE
OF
MORGAN GUARANTY TRUST COMPANY
OF NEW YORK

Before the

SUBCOMMITTEE ON INTERNATIONAL FINANCE AND
MONETARY POLICY

of the

SENATE COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS

MARCH 21, 1990

29-739 - 90 - 4

Mr. Chairman, Senators, I thought I would take a few minutes this morning to comment on how the LDC debt problem has evolved and where we are today. As with so much else in the world, change is at work, and the world of LDC debt has changed greatly in the 80's.

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The financial system as a whole is no longer threatened with possible collapse by the LDC problem. As banks have strengthened themselves, the system has been strengthened.

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When introduced in March, 1989, this was a new and complex idea that was not fully defined, and in some countries, expectations ran well ahead of reality. In spite of these early problems, complex transactions have been completed in Mexico and the Philippines; negotiations with Costa Rica are done and we are within days of completing negotiations with Venezuela. I believe the Brady Plan is working. We do have problems: what the enhancements can be used for (interest or principal?); when they are made available; and a shortage of enhancements - Japan is the only country that has joined with the World Bank and IMF in making enhancements available.

For the future - I believe we will see more ways in which to reduce debt or interest payments. The Brady Plan's enhancements are a good start, but as time passes, bankers and the debtor countries will devise ways to use enhancements more effectively.

Senator SARBANES. Thank you very much, Mr. Wagner.
Mr. McPherson.

## STATEMENT OF M. PETER McPHERSON, EXECUTIVE VICE PRESIDENT, BANK OF AMERICA, NEW YORK, NY

Mr. MCPHERSON. Mr. Chairman, it's good to have the opportunity to appear before you again.

The Brady plan broke an approaching stalemate between debtor countries and the banks.

Banks had real difficulty in dealing with the situation that had developed. They knew that the quality of the LDC debt was deteriorating but they did not have the tools usually available with distressed debtors. Many banks had concluded by the spring of 1989 that the primary recourse for them was to withhold new money. Each new money exercise was harder and harder to complete. By the time Secretary Brady proposed his plan, new money was about gone under the old system.

Debtor countries obviously had serious problems too. Some countries had made progress under the Baker plan. For example, some countries had lower ratios of debt to GNP, et cetera. However, the uncertainty surrounding the debt problem and related economic concerns were exacting a real cost to many debtor countries. For example, real interest rates in Mexico were much higher because of the unsettled situation. Also, many debtor country leaders argued that economic reform was getting very hard to impose on populations with no debt solution in sight. The threat of moratorium was everywhere, though thoughtful debtor country leaders say that, for example, the experience of Peru had been a disaster for that country.

In short, both the bankers and the debtor countries had severe problems that the process of the time didn't address. What was needed was a chapter 11 type procedure tailored to the needs of sovereign countries. The Brady plan provided a more or less orderly process for debt to be adjusted and for the debtor countries to reform their economies. This was, in fact, a chapter 11 procedure tailored to sovereign creditors.

The Brady plan got off to a bit of a shaky start. Many banks at first thought the plan was driven by U.S. foreign policy considerations rather than economic realities. Also, some banks felt the plan was oversold as almost a cookie cutter for every debtor, regardless of need. And, let's face it, the concept was new and it took everyone—banks and debtor countries—time to come to grips with the idea.

After great anguish, the banks and Mexico settled upon an agreement that probably is worth about $1.5 billion of reduced cash flow a year to Mexico and will, in fact, eliminate the problem of this debt for the next generation. The debt will be eliminated at that time because the U.S. Treasury zero bonds that back up the converted debt will pay off all that debt in 30 years. Moreover, real domestic interest rates in Mexico dropped 20 percent with the announcement of the plan, saving the country billions. I firmly believe the plan will be good for Mexico.

After Mexico, we were able to put together agreements with the Philippines and Costa Rica. Each of these agreements was different, but in each case the country had a real need plus a track record of economic reform.

Let me add a word about the Costa Rican program since my bank is the chair of the Bank Advisory Committee for the country. The banks and the country have come to agreement, though this agreement is still in the process of closing. Under the terms of the agreement at least 60 percent of the commercial bank debt will be eliminated and it is reasonable to expect that over the next 5 to 7 years virtually all of the debt will be eliminated through a debt for equity program contained in the agreement.

Venezuela was, of course, the announcement yesterday and I think a few comments about this would be helpful. Secretary Mulford has gone into it in some detail and I am quite willing, of course, to answer any questions that you might have about it, but I think there is a couple of overall comments that are worth making.

First of all, the number of options that are in the plan I think reflects the steadily greater divergence and needs and interests of the banking community and the structure was able to accommodate those needs. There was much, much less discussion among the banking community about the economic equivalency of each one of these options. On Mexico, we got tied up for weeks on whether or not almost to the penny one option equalled the other. But banks I think are beginning to say, "Well, if there's an option in the package which is acceptable to me, so be it. If somebody has another option that they like more, it is fine with me if it is a little different." This is a very positive development and the Venezuela deal reflects that divergence of need of the banks.

The vitality of that Bank Advisory Committee system was shown in the Venezuela deal. The BAC is often criticized. Banks need a BAC just as in a chapter 11, if you will, you need a committee process to work things out. But the BAC process has been criticized sometimes as slow and cumbersome and indeed initially in this BAC we were not able to make progress between Venezuela and the banks, In time we adapted quite nicely.

What we did was set up a series of subgroups. Bank of American chaired the subgroup on the debt reduction option. The other two banks you have here, Citibank chaired the new money and Morgan Guaranty chaired the temporary interest option, These subgroups developed the options and negotiated with the country. The banks that were interested in those options came to those subgroup meetings. Then we took it all back to the committee and we made quite rapid progress after the subgroup system was in place.

In short, the banking community showed some vitality to this process.

In short, I believe the Brady plan is not only alive, but in fact it's well and hearty and there's more to come.

Let me comment a moment about what has been a central theme in this whole process: economic reform of the countries.

Senator Graham, you mentioned Chairman Greenspan's success definition. Implicit in his definition was that the countries would put into place economic reforms so as to have the foundation to achieve the growth which we all seek. It's fairly easy to assume

that somehow or other there's a connection, a one-to-one connection, between the amount of debt relief and the amount of economic growth that can be achieved. However, we know that it's a much more complicated thing than that. If it wasn't, the tremendous inflows of petroleum revenues into Mexico and Nigeria in the 1970's should have permanently solved the problem, and clearly, it didn't. In fact, too many resources just meant more capital flight and/or more inflation.

In Peru, we have a moratorium for many years and a sort of debt relief, and you have nothing but an economy in shambles. Brazil and Argentina are in deep arrears and it doesn't seem to me that reduction of cash flows for debt payment per se has been an answer for them. Rather, debt relief as a support for serious, sustained economic reform is what we need.

As good as Brady plan progress has been in some ways, in the future negotiations, at least for most of them, we face a set of different conditions. Economic reform programs were in place for years in the countries which have negotiated deals, e.g., Mexico, Costa Rica, and the Philippines. But we are faced now with countries like Brazil that are just trying to put something into place. I don't suggest we wait for a couple years to figure out whether it works in Brazil but I do know that the banks are wiling to do things in connection with the Brady plan countries on the idea that some debt relief would put the countries in a better position for growth and pay back of the balance. The lack of history of economic reform, and deep arrearages in many cases, present a set of new problems that we must tackle and we will have to do it imaginatively and differently.

These differences have not been focused on yet this morning, but I just sense that in a year or two we will look back and we will say that there was almost a line here between one set of negotiations and another set of negotiations.

I'd like to close by noting that we must be working and thinking now about how to obtain continued private sector flows, equity and loans, into the developing countries. Certainly there isn't going to be another World Bank and AID or whatever resources available to provide the monies both the public and private sector need. Part of it is encouraging the flight capital back and that involves economic policies, including policies to open the country to foreign investment. Mexico is a great deal and so are some other countries. Nevertheless I think that there will be a need for organizations like the World Bank and other organizations to think very imaginatively about how to use guarantees, and other tools to provide greater leverage for money to go back into their countries.

Mr. Chairman, it's good to be here this morning and I thank you for the opportunity.

[The complete prepared statement of Mr. McPherson follows:]

TESTIMONY BEFORE THE SUBCOMMITTEE ON
INTERNATIONAL FINANCE AND MONETARY POLICY OF THE
SENATE BANKING COMMITTEE

by Peter McPherson, Executive Vice President
Bank of America

Senator Sarbanes, I appreciate the opportunity to appear before you again.

The Brady Plan broke an approaching stalemate between debtor countries and the banks.

Banks had real difficulty in dealing with the situation that had developed. They knew that the quality of the LDC debt was deteriorating but they did not have the tools usually available with distressed debtors. With a commercial debtor, banks can ask changes in the way the debtor is doing business, take more collateral and request changes in leadership. Obviously, these approaches are not generally available with a sovereign debtor. Many banks had concluded by the spring of 1989 that the primary recourse for them was to withhold new money. Each new money exercise was harder and harder to complete. By the time Secretary Brady proposed his plan, new money was about gone under the old system.

Debtor countries obviously had serious problems too. Some countries had made progress under the Baker plan e.g., some countries had lower ratios of debt to GNP, etc. However, the uncertainty surrounding the debt problem and related economic concerns were exacting a real cost to many debtor countries. For example, real interest rates in Mexico were much higher because of the unsettled situation. Also, many debtor country leaders argued that economic reform was getting very hard to impose on

populations with no debt solution in sight. The threat of moratorium was everywhere, though thoughtful debtor country leaders saw that, for example, the experience of Peru had been a disaster for that country.

In short, both the bankers and the debtor countries had severe problems that the process of the time didn't address. What was needed was a Chapter 11 type procedure tailored to the needs of sovereign countries. The Brady Plan was a broad concept, and that was important because it needed to be tested and developed as conditions demanded. The Plan encouraged banks to provide relief by use of World Bank/IMF "enhancements", and required that countries have serious reform efforts in place. In short, the Brady Plan provided a more or less orderly process for debt to be adjusted and for the debtor countries to reform their economies. This was, in fact, a Chapter 11 procedure tailored to sovereign creditors.

The Brady Plan got off to a bit of a shaky start. Many banks at first thought the plan was driven by U.S. foreign policy considerations rather than economic realities. Also, some banks felt the Plan was oversold as almost a cookie cutter for every debtor, regardless of need. And, let's face it, the concept was new and it took everyone - banks and debtor countries - time to come to grips with the idea.

After great anguish, the banks and Mexico settled upon an agreement that probably is worth about $1.5BN of reduced cash flow a year to Mexico and

will, in fact, eliminate the problem of this debt for the next generation. The debt will be eliminated at that time because the U.S. Treasury zero bonds that back up the converted debt will pay off all that debt in thirty years. Moreover, real domestic interest rates in Mexican dropped 20% with the announcement of the Plan, saving the country billions. I firmly believe the Plan will be good for Mexico.

After Mexico, we were able to put together agreements with the Philippines and Costa Rica. Each of these agreements was different, but in each case the country had a real need plus a track record of economic reform.

Let me add a word about the Costa Rican program since my bank is the Chair of the Bank Advisoiry Committee for the country. The banks and the country have come to agreement, though this agreement is still in the process of closing. Under the terms of the agreement at least 60% of the commercial bank debt will be eliminated and it is reasonable to expect that over the next five to seven years virtually all of the debt will be eliminated through a debt for equity program contained in the agreement.

We have a Venezuelan agreement announced yesterday. It includes options for debt reduction, temporary interest reduction and new money. This adds a major country to the Brady Plan with a serious economic reform program in place for about a year. In fact, it is clear that the Brady Plan is not only alive, but it is well and hearty.

Note again that economic reform is an essential component of a Brady Plan agreement. Without reform, debt reduction is wasted. Sound economic policy is the foundation for economic growth. We have Asian examples like Korea and Taiwan, and in Latin America, Chile and Mexico are benefitting from reform. Also, for example, non-traditional exports in Costa Rica now exceed coffee exports because of exchange rate devaluations and a general opening up of the economy. In short, economic policy reform is really the overriding consideration when we think about growth. Resources, including the resources released by debt reduction, can only back up economic reforms. If resources alone were the answer, then the oil revenue inflows to Nigeria and Mexico in the 70's certainly would have solved the growth problem. The biggest problems are countries where there has been little or no sustained reforms.

As stated above, the Brady Plans negotiated to date have each been with countries with sustained and sound economic programs. Tough as these agreements were to put together, they may have been easier conceptually than future agreements. The next negotiations are apparently going to be with countries that have no such economic reform history and that, in many cases, have substantial arrearages to the banks. These conditions present extremely difficult problems. The Brady Plans to date have involved permanent debt relief on the basis that countries had undertaken reforms and had lived with these programs for a time. Accordingly, banks had reason to think that the countries were in a better position to pay back the remaining debt. The international financial institutions have

agreed to provide substantial resources to support Brady Plans in part because of reform track records. Certainly different circumstances are faced by all parties if the reform efforts are new and untested. I am not saying we should stand back and wait for a couple of years to see which other countries make reform progress. Nevertheless, this second phase of the Brady Plan certainly will require the continued imagination of all parties.

Another major issue I see for the time ahead is how to get the private sector engaged again in lending to developing countries. It is critical for developing countries to have sustained private sector capital and some of this must come from abroad. There isn't enough bilateral or multilateral donor money to provide the capital that is necessary to build modern economies. The private sector no doubt will extend short term trade credit to worthy borrowers in countries that have reasonable stability. They also may be willing in time to extend longer term credit where there is collateral such as minerals or oil exports. In addition, where multinational companies provide a home office guarantee, loans will be generally available. However, it is certainly not realistic or wise to expect banks to repeat their government lending experience of the 1970s. This, at least, has the benefit of limiting the role governments are likely to play in production. For example, it will be pretty hard for a government to borrow money for a government-owned steel mill. Nonetheless, there will be finance needs that are important to the development of countries that, in fact, will be hard to come by. Many

sound private sector entities may find it impossible to attract needed equity and loans. This problem needs attention now. Of critical importance, countries can help themselves and some are taking steps. For example, economies need to be open to foreign investment and profits must be able to be taken out. Also, the World Bank and other donors really need to better use guarantees and other tools to leverage more private sector funding. Clearly this is a major problem and traditional solutions do not appear to be sufficient.

In summary, I think the Brady Plan has made an important contribution, but the next series of negotiations present some different and very tough problems. Lastly, we need to work on ways to increase the financing for countries that really are reforming.

Senator SARBANES. Gentlemen, thank you very much.

I want to ask one question I am not clear on. The packages worked out so far, do they pick one of the options or can they do a combination of the options?

Mr. RHODES. I would just suggest in most cases you can take a combination and a number of banks have so done.

Senator SARBANES. So you can put in some new money and use some of the debt relief?

Mr. RHODES. My colleagues will comment on that, but we have had banks in some cases—an example is Mexico—we had some cases where banks took both types of debt reduction, principal and interest, and split it. We have other cases where banks put in new money and took debt reduction, either principal or interest or both, and I think we will probably see the same in the Venezuelan agreement and in the Philippines you just had two options so there weren't as many to pick from.

But I think the idea as we go forward—and I think that my colleague from Bank of America, Peter McPherson, mentioned this as he went through the Venezuelan agreement that it does have a varying set of options and that's what we are looking for to allow the banks as big an opportunity to participate as possible. That also speeds up the process if there tends to be more options.

My colleagues, I'm sure, have comments on that.

Mr. WAGNER. Mexico chose a debt reduction option. They did offer a choice to banks of new money or swapping their existing loans for new bonds that resulted in debt reduction or itnerest reduction. Not many banks chose to provide new money and debt reduction. What you have to think about is what a bank is trying to achieve in a program like this and sometimes a bank runs into a conflict.

In the Philippines, for example, to put in new money, and on the other hand no off debt to be bought back is a basic conflict in the objective that a bank is trying to achieve.

It can happen, a bank might hold a particular type of debt that they want to get rid of for credit reasons and yet they are still prepared to put new money in. The pattern seems to run that a bank will pick more than one option if the options are somewhat similar, like the Mexican one. It's rarer where they cross over into putting up new money and at the same time choose debt reduction.

Senator SARBANES. How are the options, for instance in the Venezuela package, costed out to the banks? Are the banks in effect, each of the banks, to accept a certain target amount of assistance and then they can choose among the options in order to achieve that target? I guess what I'm really getting at is how do you ensure that all banks are bearing roughly equal burden?

Mr. RHODES. I think you get participation of everyone into the package. It really gets down to the question of having sufficient options so everyone participates. And the feeling is that when you put these packages together, if everyone participates in one or the other options, there will be sufficient debt reduction or new money to cover the needs.

I think that in the case of taking different options, Peter, you might want to comment on that because your bank did in effect take several different options in the case of Mexico.

Mr. MCPHERSON. In the case of Mexico, as Bill says, Bank of America did take some new money and we took the interest reduction option for the lion share of our debt.

It is envisioned that most, if not all, banks will take every dollar of their debt and either sell it back to the Venezuelans in the buyback or select one of the other options. So all debt or nearly all debt will bear the burden or the opportunity of one of the options that the committee and the Venezuelans developed.

Senator SARBANES. There's been on occasion some talk in the Congress of trying to find some way of applying sanctions that will stick to banks who try to be a free rider.

First of all, how serious is the free rider problem and what is your reaction to the notion that we might in some way or other try to find some way to put some pressure on those who try to get a free ride?

Mr. MCPHERSON. I think it's worth noting in the Mexican case that we may have 100 percent participation. I believe that in the Costa Rica program, which still has to be closed—the Costa Ricans and the banks have negotiated the deal—that there will be very, very substantial participation.

Senator SARBANES. So you're saying, in effect, the issue is moot?

Mr. MCPHERSON. It doesn't seem like a pressing problem.

Senator SARBANES. Let me just make this observation. If it should not prove to be the case, I think there's considerable concern in the Congress that would develop rather quickly about free riders and what would be perceived as an abusing of their colleagues or compatriots in trying to work out this problem.

In other words, I think it's very important that they participate and it's encouraging in the Mexico report and hopefully that will take place elsewhere, but I think there ought to be some sense of a strongly negative reaction in the Congress if there should begin to grow a group that sort of tries to ride this thing out without bearing any share of the burden.

Mr. MCPHERSON. That's an interesting balance here because, on the one hand, those who are participating want broad participation and the country also does. On the other hand, you want to be sure that there isn't too much government mandating of things because to the extent that you have such mandating you may end up having a longer-term negative impact on investment and loans going back to the country.

In fact, I believe that there will be hearings in this room in a year or two as to how we can stimulate further investment in these countries. We are making some progress and we want to be very sure that we don't hinder solutions for tomorrow's problems by today's solutions.

Mr. Chairman and Senator Graham, you have been sensitive to this in the past, but I do make the point.

Senator SARBANES. I take it the precedent problem of the cookie cutter mold has diminished in the concern that the banks have about that. Is that correct?

Mr. WAGNER. Well, I think that's right. In Venezuela, there are more options, five of them, and there is an option that is quite similar to the Mexican transaction, but there are enough other options, we believe, to appeal to all of the banks.

Just to expand a little bit on your question, there isn't any way that we can assure that all banks will come in. The way we do that is to negotiate enough options to appeal to the banking community and then price them in a way that will bring them into the transaction.

If Congress should legislate or work out some way of penalizing banks that don't come in, there's a risk that you will distort the negotiating process and you'll get a result that isn't really oriented toward the market. In a sense, that will almost encourage banks not to come in and you will have free riders. Your might get, through the penalties, the U.S. banks to come in, but in all of these countries there are many creditor banks from around the world. The best way, we believe—and Mexico has proven this—if banks get choices, and they are priced right, the banks will come in. We think that's going to work in Venezuela, but we won't know until it's done.

Mr. RHODES. Mr. Chairman, just to give my thoughts on that, I would agree with both points of my colleagues on the sense of the need to think about new investment ongoing because that's key to these countries.

Second of all, the comment on the various options and pricing them. Also, we should remember—and I remember having a conversation with Senator Graham on this—the U.S. banks in most of these packages are only 25 to 30 percent of the total and in order to get the worldwide banking community we have to put something together that appeals to everyone.

Also, we should not forget that the countries themselves have means to deal with what we call free riders because at the end of the day, although all of us who participate actively in this want to see everybody else there, because you need that type of a response, the countries are the most interested party themselves and they feel very strongly that the banking community as a whole participate and they have their carrot and stick approach in doing so. I know both of you gentlemen have talked to these countries and are aware of that.

So I think, hopefully, we can repeat the experience of Mexico in the various countries we are talking about as we go forward and, at the same time, we can accelerate the process of getting these things done because it's as frustrating for us sometimes, the slowness, as it is for all of you who sit and watch it, as it is for the debtor country.

Senator SARBANES. Thank you. I have a couple more questions. I yield to Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

I have basically three questions. The first is the same question that I asked Mr. Mulford earlier and have been asking at previous hearings. That is, what are the standards by which you will be evaluating the success of the agreements which have been entered? Mr. Rhodes, Mr. Wagner, Mr. McPherson, if you were advising this subcommittee as to what we should be monitoring in terms of assessing the success of this program, what would you recommend and what are you in fact looking to in terms of your own banks?

Mr. RHODES. In monitoring what is being done, I think it's very important that the countries are implementing the type of econom-

ic reform that we all know that they need to—opening the economy, privatizing and things like that.

I think one of the points that has to be followed very closely are the reform programs in these countries to see that they actually implement them because it's one thing to announce an economic reform program and it's another to implement it.

We have seen, in some countries, stop-and-go progress in that regard. I feel confident that Mexico now is on a sustained path of reforming its economy. So that is one point.

I think another one is the question of reaching agreements between the countries and the commercial banks that give the countries sufficient financing to move ahead their reform programs. In other words, through voluntary debt reduction and new money, where necessary, the funds are there, through either one of the two, to finance their programs going forward.

I think it is also very important not to forget the role of the creditor countries here because so far we have been basically talking about the commercial banks and the debtor countries and I think it's very important that the official sector play its role, for example, through the international financial institutions—the IMF, the World Bank and the regional development banks like the Inter-American Development Bank. In this regard, I must say that the new President of the IDB, Enrique Iglesias, has been very active in this process. Also through the Paris Club, the various Eximbanks of the countries—that they give their support to this process.

Now the path of the international financial institutions has been to provide new money and money for enhancements. So far the Paris Club has been giving new money and some debt relief, and the Eximbanks are giving new money, although the Eximbank in Japan has been working on the enhancement side also, as in the case of Mexico.

So I think really what you need to do is you need to monitor everybody because it's not any one group. If we cannot work ahead in a cooperative fashion, these programs are not going to work. So each party has its bit to do. If any one of them falters or fails, then the program is probably going to get into trouble. So I would suggest that's how you look at it. Certainly, that's how we look at it in speaking for my own institution.

Senator GRAHAM. I would be interested, Mr. Rhodes, and I make the same request of Mr. Wagner and Mr. McPherson if you could provide us with some further information as to what are the specific data bases or quantifiable or observable events that you would look to to determine whether those generalized statements, such as continued economic reform seriously implemented, are in fact being achieved.

Mr. RHODES. I think that most of these economic reform programs have elements to control or reduce inflation, to get the country back to growth, to open up the markets, to privatize, to open up to direct investment, to create additional internal savings as well as obtaining private investment. I think you have the whole area of capital flight which is much more difficult to track, as you all know.

Everyone talks about capital flight, but it's easier to talk about than to track. But you can take a look at the reserve buildups and

the amount of investment and I think those are the type of statistics you have to take a look at over time, not on a one-shot basis. I think all three of us have stated this is not a one-shot situation. You have to look at it over time.

I think that the question of the financing, again by the commercial banks, whether it be debt reduction or new money, has to be looked at over time, whether the countries are in effect receiving that.

I gave specifics where the interim committee of the G–7 and the IMF and World Bank can make changes to accelerate this process and I think you need to watch what's going on there in their policies toward these various countries.

As I said, I listed some specifics that I think need to be dealt with along this line, but these cannot be looked at just in the short term, and I think both of you made that point earlier in your questions. You've got to do it over time.

Senator GRAHAM. This is a video tape, not a polaroid camera.

Mr. RHODES. Exactly. It's not a shot in time. We kid ourselves—and I think Peter's comment was very accurate—that a year from now we may be here saying, "OK, we've been through these debt reduction programs and reform programs, but these countries need continuing investment to make their programs go." The Mexicans have said that. The Mexicans have said so specifically in their case, when asked, "Where are you going to get the financing?" They divide it into three parts. One-third, they say, will come from the international financial institutions and the Eximbanks of the world. Another third would come from increased direct investment, return of capital flight, et cetera. Third, they plan to go into the market and do voluntary deals.

I mentioned the negative pledge clause because a lot of these things will be receivables type situations. The countries will also go in and be actively dealing in their own paper, which will be traded, and to do market operations like that.

So I think you need to follow what occurs in a situation where a country has finalized its debt reduction program, new money program, with the banks, and how it finances itself going forward. Again, as you say, you need a video tape in time, not just a one-shot snapshot.

Senator GRAHAM. Mr. Wagner.

Mr. WAGNER. Well, we look at the growth rate and follow that very closely and we review how a country is controlling inflation. We really want to see growth with low inflation and we want to see the type of growth. You can have some dramatic periods of growth, but it can be fueled by very large public sector projects which are terrific while they are going on, but once they are completed then you suddenly have a lot of people back out on the job market looking for jobs again and you don't have the longer-term, sustained growth that you really should develop.

So we like to see growth really fueled by a healthy development in industry and in agriculture, that are providing jobs on a longer-term basis and that are going to multiply.

We also look at the foreign exchange earnings, how their exports and service earnings are progressing. It might be tourism or it might be shipping or whatever it may be, and we watch this be-

cause a country is always going to need a certain amount of foreign exchange to pay for all sorts of things—imports, servicing debt, whatever it may be—so it's important to watch what sort of progress they are making on their foreign exchange earnings.

We also are watching pretty closely their debt, both domestic debt and foreign debt. A lot of these countries have a bigger problem coping with their domestic debt than their foreign debt. It's hard to believe when you think of all the time we devote to the foreign debt, but many countries have very weak systems of collecting taxes and controlling their government expenses, and it gets away from them and they start borrowing and up goes the domestic debt.

So basically, we are looking at growth, but you can't just look at the number. You have to go behind it a bit to see what kind of growth it is. Inflation—Brazil has had pretty good growth, stripping out the inflation, but they've got this incredible inflation and this new program goes after that. Even with the growth they were having, they were headed toward serious difficulties with that inflation. So we look at that, at the form of growth. We're looking at the inflation. We're looking at foreign exchange earnings and we are also looking at debt. Those are the kind of key things we keep watching.

Mr. MCPHERSON. Every country will have a different set of concerns that you need to focus on. Over a period of time the bottom line is broad-based economic growth. But year by year each country is unique because, for example, when I looked at Costa Rica over the last decade—I did AID, in Treasury and then here at the bank—to me, the key time in the recent economic history of that country was when nontraditional exports exceeded coffee exports. That time came about the middle of the 1980's. There is no question that critical to achieving that such exports was a devaluation of the currency and the general opening up of the economy. The CBI helped. When, in short, the Costa Rican economy became sufficiently restructured so as to have nontraditional exports growing at 20-some percent or so a year, I think that was key.

Various considerations like that will be critical in each country. An important part of history of the 1980's in the developing world was the ebb and flow of the economic reform efforts. The privatizations, the decontrol of agricultural prices to farmers, a whole range of issues. And countries that have succeeded, that have made real progress, have been those who have been willing to face up early on and see that the old structures basically favored an elite. Those who didn't, those who weren't willing to do it under the guise of the sacrifices involved, et cetera, haven't made much economic progress.

I think, by the way, that economic reform is not just a Third World issue. It's our issue. We've got to have a new GATT agreement. I can't help but as an old AID administrator take this opportunity to say that I often felt that the AID program that I administered for Jamaica, a country spoken of here this morning, was overwhelmed by our sugar quota.

The reality is that what the United States and other developed countries do in terms of economic policy has a tremendous impact

and there needs to be synergy between our efforts and developing country efforts.

Senator GRAHAM. Thank you. Mr. Chairman, I have a couple more questions, but I'll defer.

Senator SARBANES. Go ahead.

Senator GRAHAM. If I could comment on the last statement Mr. McPherson made, as this morning has progressed, I have been struck with how well the United States, if asked to stand the test of its own economic policies over the last decade, would stand up vis-a-vis the countries that we are focusing our attention on.

Mr. Rhodes, when we do an analysis of economic reform from both the standpoint of the debtor countries and the creditor countries, I think the United States ought to have a report card in both categories and see how well we are doing with our economic policies.

Mr. RHODES. I agree. I would just like to add one point to what I had said.

I think when we look at the indicators—I had mentioned internal savings. I'd like to reemphasize that, because, if you look at the increase in the internal debt, I think Rod Wagner was very correct when he said some of the countries—Mexico and Brazil are examples—spend more money servicing the internal debt than the external debt and, in a sense, it's a bigger problem. That's why the Brazilians are tackling that first.

The other side of that is the internal savings and that's one way to monitor the situation with the private sector as well as the retention of capital in the country or the return of capital, so-called flight capital. So watching what goes on with the internal savings in a country is a very key indicator.

I agree with you, by the way, on the report card for the creditor countries.

Senator GRAHAM. Mr. Chairman, if I could, the second question was all of you emphasized the importance of a climate that would encourage new investment as well as principal and interest write-down on the old debt.

Mr. McPherson, in today's Wall Street Journal, you are quoted as saying, "There are indications that there may be, fortunately, more new money in Venezuela than in the case of Mexico."

I was curious as to what had contributed to your expectation of more new money in Venezuela than Mexico.

Mr. MCPHERSON. I think we have to wait and see how all the options develop in detail for banks to make the choice, but, informally, several banks have expressed some real interest in the new money option.

In Venezuela you have a resource base that helps banks think about that carefully. Some $3 trillion or so of proven reserves of petroleum, gold, bauxite, iron ore, et cetera. It may be that as all new money/debt reduction options are fully developed we will find that the proportions are no different than that of Mexico, but at least at this stage in the negotiation process there is more interest in new money than we ended up with in Mexico.

Senator GRAHAM. I have a final question to Mr. Wagner. You said that you wanted to take a few minutes to put what we are

doing in some historic perspective. I'd like to go back to a slightly earlier period from the mid-1970's into the early 1980's.

What would be your historic assessment of the lending practices and standards used by commercial banks in these Third World countries during that period when most of the debt was being accumulated? And in the context of that assessment, do you have any recommendations of what, if anything, should be done vis-a-vis either practices by the institutions themselves or by regulatory agencies that have responsibility for the financial safety and security of these institutions?

Mr. WAGNER. Well, I'd say beware of the latest fad. Obviously the banks got caught up and they overlent heavily in Latin America. I think all of us have spent time looking back at that and thinking about how we should look at other opportunities in the future. Some of us have probably been more careful than others in looking at trends. But you're always going to have some fads that are going to come along. Unfortunately, a lot of banks are having difficulty today in the real estate area. They probably are going to look back and say we got a little carried away and lent too much and let our standards drop.

You need good supervisory people carrying out their duties effectively, and I think we've got some good supervisory people doing that these days.

I think also a few people are going to have to lose some money and that is a wonderful way to make people be a little more careful about what they are doing.

I would also say that the nature of our banking system, where we've got 14,000 banks around the country, sort of leads to people not remembering some of these experiences. If you had fewer banks and more of a national basis, you probably would have better control over some of this than exists now.

I think it's the nature of banking that there are going to be some losses and they are probably going to run in some patterns and I don't think that's going to go away.

Senator GRAHAM. Thank you, Mr. Chairman.

Senator SARBANES. I have two very quick questions.

What other countries could make enhancements available? Who are prospects for the other countries to provide enhancements.

Mr. RHODES. I had stated in my comments that I thought other surplus countries—Japan is doing it—I think the European Economic Community is talking about—has been specific in some cases—about recycling to Eastern Europe. I think that we could use more of that for Latin America also.

Mr. MCPHERSON. Dr. Rodriguez, the head of the Ministry of Planning, yesterday in the press conference on Venezuela, mentioned that they thought they would receive some resources from Spain, which I thought was interesting.

Senator SARBANES. I was concerned by Peter McPherson's perception that we had reached a line at this point in dealing with debtor countries that it had become difficult, more complex, so much so that it would be almost a matter of time rather than degree that you would look back and see a line.

I wonder whether the other two agree with that and I'm interested in what debtor countries are prospects for the very near future of being put through these plans.

I am concerned if, in fact, we have reached that state of difficulty this early in the process, so much so that you perceive a shifting in kind.

Mr. MCPHERSON. If I could clarify that remark a moment, Mr. Chairman, I think we will continue to have negotiations and progress and there are some countries like Uruguay, for example, that don't have arrearages and that have had a serious economic reform program for some time. But I do believe that we have somewhat of a different set of circumstances with a Brazil that is just beginning an economic reform program. And I think that will require imagination and effort on our part and we will have to produce some perhaps different approaches or answers. I don't think we can wait 6 months or a year or something and decide whether Brazil is doing the right thing before we engage them, however.

Mr. RHODES. To be specific, Mr. Chairman, right now there are conversations going on in Paris with the Moroccan Government to try and reach an agreement. How long that will take I don't know, but I would imagine in the next several months agreement will be reached.

In the case of Uruguay—and Peter has commented on it—the President of Uruguay was in New York about a month ago just prior to his inauguration and I saw him and he and his finance minister said that starting in April they want to sit down with the banks and reach an agreement on a new plan. I would imagine, for the reasons that Peter has stated already, and the good record we've seen in Uruguay in their growth program, that we can reach a speedy agreement.

People sometimes like to avoid the other two, which are the two largest debtor nations that are still pending. Brazil's economic program—which was announced on Friday and points are still coming out on it—is a very important one because it addresses some of the serious internal problems of inflation and the growth of the public sector. The program will not be implemented overnight obviously. It's a very complex, innovative program. In fact, some people are saying it is the most complex, innovative and massive attack on inflation and instability since the 1948 reforms of Ludwig Erhart in West Germany.

I think the problem here is that we have to see the implementation. But they have indicated to us that they will be talking to us in the course of the next few weeks to advise us when they will sit down with the bank advisory committee. I had an opportunity to talk twice with the then President-elect Collor, and he mentioned that he wanted to send a team up as soon as possible to start negotiations with the banks.

I think it's fair to say that these will not be easy negotiations because there are many problems, but I am sure, like in the case of Mexico and Venezuela, we will reach agreement.

In the case of Argentina—and I was recently in Argentina and saw President Menon and his economic team—I think you have a situation where there is a pending negotiation with the Fund and

obviously there are a number of problems that we all are aware of, but the President states, every time he is asked publicly, that he is going to pursue a program of opening the economy, privatization, and putting the finances in order.

How long that will take, nobody knows. But I went down there as chairman of the bank committee to advise the Government that the committee was prepared to sit down and talk when they had a program in hand with the IMF and they are working on that now.

So I don't think any of these cases are easy, but I think the banks have shown that they are prepared to sit down and work them out and I think we will do so over time.

Senator SARBANES. Fine. Well, gentlemen, we thank you very much for your testimony. It's been very helpful. Let me just make this closing comment.

I do want to say that I think each of you, the three of you as individuals, have made a very positive and constructive contribution toward this issue. You have been point men at various times in the negotiations and I think you have made a contribution to defusing the situation and moving it away from potential confrontation toward a joint effort to arrive at a solution that serves everyone's mutual interest.

I know it's been very demanding on you in terms of your own commitment of time and effort and energy and concern and worry and I just wanted to put that on the record here today. We thank you very much for being with us.

We are very pleased to have as our final panel at this hearing on the Third World debt strategy two highly respected outside observers, Abraham Lowenthal, executive director of the Inter-American Dialogue; and Sidney Weintraub, Dean Rusk Professor, LBJ School of Public Affairs, at the University of Texas.

Gentlemen, I know it's been a long morning. We appreciate your patience and we look forward to hearing from you now. Unless you have worked out an arrangement, I will just take you alphabetically.

Mr. Lowenthal, why don't you start off?

## STATEMENT OF ABRAHAM LOWENTHAL, EXECUTIVE DIRECTOR, INTER-AMERICAN DIALOGUE, WASHINGTON, DC

Mr. LOWENTHAL. Thank you, Mr. Chairman.

It is an honor to testify in these hearings. I am pleased to do so particularly with my colleague and friend, Sidney Weintraub, and after hearing such informative testimony earlier this morning.

I testify, of course, as an individual and without pretending to represent the Inter-American Dialogue, but I certainly have drawn on the Dialogue's studies and discussions in preparing my remarks and I've submitted for the record some of the Dialogue's work and that of my colleague, Peter Hakim.

In my brief remarks, I would like to focus on the Latin American debt from a broad perspective and to address two underlying questions: How is Latin America today being affected by the prolonged and massive debt overhang? And what difference will Latin America's problems or its possible achievements make for us in the United States in the 1990's?

In my prepared statement, which I've submitted in full, I review the situation in Latin America at the beginning of the 1990's. Obviously, the 1980's were a period of great difficulty and decline. In economic terms, a 10 percent regional decline in per capita income, far more severe in some countries and in some regions, high unemployment, inflation, with inequality getting worse. And America's terms of trade has been deteriorating. All of this translates in human terms into hunger, infant deaths, boat people and feet people, stunted education, epidemics, street crimes and delinquency, and mounting despair. And in political terms, into the overwhelming repudiation of incumbent governments in almost every election; increasing political polarization in many nations; growing insurgencies and terrorist violence in a few.

I discuss five broad regional trends which I will just mention without going into detail.

First, the cumulative effect of the "lost decade" in terms of investment, social programs and the like.

Second, the difficulties being posed for democratic governance. After an exhilarating period of democratic opening, democratic regimes are having great problems in meeting the challenges posed by economic decline, particularly in those countries where there are prolonged insurgencies, the narcotics traffic, rampant corruption, labor unrest, and widespread disillusion and disaffection.

Third, the tension in many countries of Latin America between the processes and consequences of political and economic liberalization, between opening politics and opening markets. In our country, we often assume that market economics and democratic politics necessarily go together, as they do in our country; and the parallel moves in the late 1980's toward democratic opening and liberal economic reforms in Latin America seemed to support this view. But in the 1990's there may very well be tensions between these trends and that may raise serious difficulties in various countries.

Fourth, I emphasize in my prepared testimony the differences which have emerged among the countries and subregions of Latin America and the Caribbean, which we really need to look at in individual terms, as I try to do in the prepared statement.

Fifth, after this strong dose of realism, not to say pessimism, I do try to point to some of the positive factors which we see in Latin America—declining fertility rates, the structural reforms which have already been undertaken in several countries, the fact that a number of nations have been able to expand their exports, the improved capacity of the citizens of Latin America as a result particularly of expanded education over the last generation, the growth of grassroots and popular organizations which have achieved a level of vibrancy in Latin America unprecedented in that continent's history, and the regional commitment to human rights and democratic politics.

But, in sum, Latin America today is in a difficult state, with political advances and social gains threatened by the massive and unsustainable debt burden. If viable solutions for the debt problem could be fashioned, Latin America's underlying process of modernization over the last generation and the exciting reforms underway in many countries could produce quick and substantial advances in many countries. But if no significant debt relief for Latin America

is forthcoming, the region's "lost decade" could become two lost decades, with grave social, economic and political consequences for the region.

What difference would that make for us in the United States?

There are those who argue that the United States has much less at stake in Latin America than it did years and decades ago. They point out that the share of U.S. investment and trade concentrated in Latin America is much less than it used to be; that Latin America is virtually irrelevant for the military security of the United States in a world of shifting geopolitics and changed technology; and that the presumed diplomatic solidarity of Latin America with the United States is both less real and less significant than it used to be.

Frankly, I agree with those critiques. In traditional terms, Latin America is less and less important for the United States. If traditional interests were all that was at stake in Latin America today, we could afford to pay even less attention to the region than the sporadic attention it has received from our government over the past years.

But I would hasten to add—and this is the main point I really wish to offer to the committee—that Latin America may well be increasingly significant for the United States in the 1990's in a transformed global context that will permit and even compel greater attention to the domestic concerns of the American people for which Latin America will be most relevant.

Latin America's new importance for the United States, not yet fully appreciated I think by U.S. policy-makers, derives from the region's proximity and size, and from its degree of interconnection and even interpenetration with the United States. The military security of the United States is no longer seriously menaced by direct attack from the Western Hemisphere, but U.S. security in a broader sense—the capacity to protect the individual and collective welfare of our country's citizens in all parts of the country—will be affected by Latin America precisely because the region is close, large, growing demographically and demonstrably capable of economic growth, and especially because it is already so intertwined with the United States.

The impact of Latin America on the United States will derive from its economic importance, the influence of migration, the region's capacity to affect important shared problems facing our society, and its significance for promoting core values at the heart of our country. I develop these points more fully in the prepared testimony.

Economically, Latin America's importance as an export market for the United States could sharply increase in the 1990's if the region could overcome its debt-induced depression. It could be very important in terms of increasing U.S. exports and it could again become a significant area for U.S. banking operations.

The second and growing importance of Latin America for the United States derives from massive and sustained migration, especially from Mexico, the Caribbean, and Central America. Migration affects the United States in many ways, shaping education, employment, public health, business, politics, culture, mores, and cuisine.

Latin America is also important for the United States today because of major problems facing this country that cannot be solved without sustained and intimate cooperation from Western Hemisphere nations. The most dramatic example is narcotics, but there are other vital issues on which Latin America's cooperation may well make a critical difference, such as environmental protection, resource development and management, including the provision of secure sources of energy, combating terrorism, and curbing nuclear proliferation.

Finally, the prospects for preserving values at the core of U.S. society—particularly respect for individual human rights—are significantly affected by conditions throughout the hemisphere.

These four main ways that Latin America will matter for the United States in the 1990's have important implications for the formulation of our policies in the Western Hemisphere.

First, they suggest why the United States should recognize that it has a growing objective stake in Latin America's economic, social and political realities. In an earlier era, when what mattered to Washington in the Western Hemisphere mainly had to do with military bases, access to materials, the investments of a few firms and the diplomatic support of client-state governments—well, maybe the United States could afford sometimes to be callous about internal conditions in Latin America.

But if what concerns the United States about the region is its capacity to buy our products and repay its loans, the rate and nature of migration, the prospects for sustained and effective cooperation on tough shared problems and the protection of fundamental human rights, then we should become profoundly interested in the internal conditions of our neighbors.

Second, this framework suggests which Latin American countries ought to be of greatest interest to the United States and why. Mexico, Brazil, the Andean countries, Venezuela, and the countries of the Caribbean.

Third, the issues at the heart of United States-Latin American relations in the 1990's will increasingly be what Bayless Manning once called "intermestic" issues; that is, issues involving both international and domestic aspects and actors. These include trade, immigration, narcotics control, resource development, and environmental protection and others.

Fourth, contrary to what some people are saying in the wake of the exciting events in Eastern Europe and elsewhere, I believe that Latin America will be of heightened relative importance to the United States. For those who have seen the world almost exclusively in cold war terms, the events of 1989 have made Latin America now seem virtually irrelevant, likely to fall off the map. But as U.S. interests and energies turn inward to challenges like controlling drugs, assuring adequate and secure sources of energy, protecting the environment, assimilating new waves of immigrants, Latin America may well come to be understood as increasingly important.

In conclusion, Latin America's chances for economic growth, social equality, political stability, continued democratic opening and respect for human rights all depend to a significant extent on substantial regional debt relief.

The interests of the United States are deeply engaged in Latin America's prospects for renewed growth, social equality, and democratic consolidation.

For those reasons, Mr. Chairman, I believe the Senate and the U.S. Government in general should, with some urgency, be seeking ways to help assure a broader and more rapid alleviation of Latin America's debt burdens.

In the question period, if asked, I would be delighted to try to add to that in terms of some of the things I think the government could do.

[The complete prepared statement of Abraham F. Lowenthal follows:]

**Opening Statement**
**prepared by Abraham F. Lowenthal**
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**University of Southern California**
**and**
**Executive Director**
**Inter-American Dialogue**

**for**
**Hearing before the Subcommittee**
**on International Finance and Monetary Policy,**
**Senate Banking Committee**

**(March 21, 1990)**

Mr. Chairman, members of the Committee:

It is an honor to testify in these important hearings on Third World debt, with its particular focus on Latin America.

I am pleased to be able to participate in the Hearing, particularly in the company of such a distinguished and congenial panel and after hearing such important and informative testimony earlier this morning from the Administration and from the commercial banking community.

In testifying, of course, I do so as an individual and without pretending formally to represent the Inter-American Dialogue, of which I am executive director and Mr. Petty is a member of the Executive Committee, but I certainly have drawn on the Dialogue's studies and discussions in preparing my remarks. In particular, I am indebted to my colleague Peter Hakim, the Dialogue's staff director, who has been following the debt negotiations more closely than I. With your permission, Mr. Chairman, I would like to offer for the Committee's files and record two of Mr. Hakim's recent newspaper articles, one from the Los Angeles Times and the other from the Chicago Tribune, which provide a detailed statement of the virtues and limits of Secretary Brady's approach to the Latin American debt problem.

In today's testimony we have an appraisal of the Third World debt situation from the perspective of a very senior official of the Treasury Department and evaluations of the issue from the standpoint of several major commercial banks. In this panel, my friends Bill Rhodes of CITICORP and Sid Weintraub of the University of Texas are far more qualified than I to assess the agreements on debt that have been reached with the Philippines, Costa Rica, Mexico and now apparently with Venezuela, to evaluate the prospects for concluding agreements soon with the countries currently in negotiations, and to provide their appraisal of the outlook for key debtor countries such as Brazil and Argentina which are currently not in negotiations with the commercial banks.

In my brief opening remarks, I should like to focus on the Latin American debt from a broad political perspective, and to address two underlying questions: How is Latin America being affected by the prolonged and massive external debt overhang? And what difference will Latin America's problems or achievements make for us in the United States in the 1990s?

As I say in the article on "Latin America Enters the 1990s," that I recently prepared for the Harvard International Review, a copy of which I have made available to the Committee's staff, it is hard to be optimistic about Latin America and the Caribbean in today's circumstances. During the 1980s, Latin America suffered a nearly 10% regional decline in per capita income, and a far more severe drop in some countries and sub-regions. Unemployment and underdevelopment are high, inflation plagues many nations and hyper-inflation ravages a few, and socioeconomic inequalities are almost everywhere getting worse. Latin America's share of world commerce fell during the 1980s from almost 6% to 3.5%. Its terms of trade worsened markedly, with a decline in the real value of almost all its commodity exports.

Translated into human terms, the statistics on Latin America's plight mean hunger, infant death, boat people and feet people, stunted education, epidemics, street crime and delinquency, and mounting despair. The political residue of the 1980s, in turn, is overwhelming repudiation of incumbent governments in almost every election; increasing political polarization in many nations; incipient questioning of the democratic framework in several; and growing insurgencies and terrorist violence in a few.

At the beginning of the 1990s, five broad regional trends deserve special emphasis.

First, throughout Latin America and the Caribbean, the cumulative effects of the Lost Decade are becoming evident. Latin America's industrial infrastructure is eroding, the results of curtailed investments in education and research are beginning to be felt, social and health problems are mounting, and there is almost everywhere a sense of urgent crisis. It is widely recognized that most of Latin America cannot count on significant external capital during the 1990s -- that neither renewed foreign investments nor new commercial lending are likely to enter the region on a broad scale in substantial amounts.

It appears increasingly improbable that the debt crisis of the 1980s will ever be "resolved" with a clear and comprehensive solution; it will more likely be managed, on a case by case basis, on terms that reflect the divergent interests and relative strengths of the various actors and that consequently leave most Latin American nations bereft. Small regional banks in the United States, as well as many European and Japanese banks, are simply withdrawing from the region, cutting their loses. Large money-center banks are grudgingly reducing their expectations and are wary of new or expanded involvements. The very difficult challenge faced by many countries throughout the region is how to design economic development strategies that can mobilize domestic savings and reattract flight capital without counting on much external capital and without aggravating socio-economic inequalities and tensions. Without international assistance, this challenge may be overwhelming for many Latin American nations.

Second, the exhilarating progress of democratic opening throughout Latin America is giving way to preoccupation with issues of governance and governability. It is hard for fragile democratic regimes to meet the challenges posed by economic decline, particularly when that is accompanied by prolonged insurgencies, the narcotics traffic, rampant corruption, increasing labor unrest, and widespread disillusion and disaffection. After several years of strong reinforcement of Latin America's moderate center -- as part of the process of abertura -- much of the region seems now to be entering a renewed phase of polarization. Both leftist and rightist (or neo-conservative) groups and leaders are gaining greater strength, sometimes in the same countries.

Third, much of Latin America and the Caribbean -- from Argentina to Mexico -- is experiencing growing tension between the processes and consequences of political and economic liberalization, between opening politics and opening markets. In the United States, it is widely assumed that market economics and democratic politics necessarily accompany and reinforce each other; the parallel moves in the late 1980s toward democratic opening and liberal economic reforms in Latin America seemed to support this view. But the impressive strength in the late 1980s of Cardenas in Mexico, Lula in Brazil, the Frente

Amplio and Nuevo Espacio in Uruguay, and of MAS and Causa R in Venezuela raise serious questions -- a bit different in each case -- as to whether more democratic participation may eventually spawn renewed populist, statist, and possibly nationalist approaches and policies early in the early 1990s, and whether the emergence of such challenges may produce moves to restrict democratic competition. Throughout the region, too, there are serious concerns as to whether the choices made by political actors in order to ensure the survivability of fragile democracies may make it less likely for democratic regimes to confront the fundamental problems of poverty and gross inequality.

Fourth, the differences among the countries and subregions of Latin America and the Caribbean -- always much greater than most North American policy analysis or public discussion assume -- are becoming more pronounced than ever:

-- Mexico and many of the islands of the Caribbean are silently integrating with the United States, in the sense that their economies are ever more closely intertwined with ours, and their people are migrating to this country at an accelerated rate. Mexico, in particular, seems embarked on a course of policy that, if sustained over time, may make it increasingly a North American nation, ever more different and removed from Latin America.

-- Peru and to a lesser extent Colombia, on the other hand, are showing worrisome signs of disintegration, with whole regions of each country under the control of insurgent movements, counter-insurgent paramilitary groups and/or drug traffickers, and with the legitimacy and authority of the central national government ever more precarious.

-- Central America, the focal point of so much struggle during the 1980s, is now poised uncertainly between the possibility of peace through utter exhaustion, the prospect of renewed and more violent confrontation, or years more of low-level but deadly conflict.

-- Argentina, Brazil, and to some extent Venezuela are internally divided, with growing uncertainty and the possibility of quick policy reversals and even of turbulence in each case. In all three countries, proponents of market-oriented orthodoxy have dominant influence at the moment, but in each case those who espouse neopopulist heterodox formulas are strong contenders for power. In none of these three countries is it at all certain what policy approaches will prevail in the next two or three years, or even whether the established political rules will survive.

-- Chile and Uruguay, meanwhile, enter the 1990s in relatively strong shape, as each enjoys the fruits of restored democratic politics and, in the case of Chile, of a newly modernized economy. In each country, however, the moderate centrists who hold power as the decade begins may soon face challenges from both sides that will make it difficult to retain simultaneously business confidence and broad popular support.

Fifth, even if there are strong reasons for concern about Latin America's immediate future, it is also important to stress some reasons for longer term optimism about the region's overall prospects. Declining fertility rates throughout most of Latin America augur well for an improving balance between resources and population, and between economic growth and expansion of the labor market. The structural reforms already undertaken in

several countries increase the likelihood that Latin America, or at least part of the region, will eventually be able to insert itself more fruitfully into the evolving world economy. Even during the 1980s, the region's exports expanded over 50% by volume. A generation of urbanization and expanded education has modernized Latin America and greatly improved the capacity of its citizens. In many countries, grass-roots and popular organizations are gaining vibrant strength unprecedented in Latin America's history. And the regional commitment to human rights and democratic politics, however fragile, is also noteworthy; many Latin American countries may finally escape the syndrome of repeated military interventions.

In sum, Latin America today is a in a parlous state, with political advances and social gains threatened by the massive and unsustainable debt burden. If viable solutions for the debt problem could be fashioned, Latin America's underlying process of modernization and the exciting reforms underway in many countries could produce quick and substantial advances. But if no significant debt relief for Latin America is forthcoming, the region's "lost decade" could become two, with grave social, economic, and political consequences.

Let me turn then, to my second question: What difference will Latin America's problems or achievements make for us in the United States?

There are those who argue that the United States has much less at stake in Latin America than it did years and decades ago. They point out that the share of U.S. investment and trade concentrated in Latin America is much less than it was; that Latin America is virtually irrelevant for the military security of the United States in a world of changed technology and shifting geopolitics; and that Latin America's presumed diplomatic solidarity with the United States is both less real and less significant than it once was. I agree with these critiques; in traditional terms, Latin America is less and less important for the United States, and if traditional interests were all that is at stake in Latin America, we could afford to pay even less attention to the region.

But I would hasten to add -- and this is the main point I wish to make today -- that Latin America may well be increasingly significant for the United States in the 1990s, in a transformed global context that will permit and even compel greater attention to the domestic concerns of the American people.

Latin America's new importance for the United States, not yet fully appreciated or explicitly articulated by U.S. policy-makers, derives from the region's proximity and size, and from its degree of interconnection and even interpenetration with the United States. U.S. military security is no longer seriously menaced by direct attack from the Western Hemisphere. But U.S. security in a broader sense -- the capacity to protect the individual and collective welfare of this country's citizens -- will be affected by Latin America precisely because the region is close, large, growing demographically and demonstrably capable of economic growth, and especially because it is already so intertwined with the United States.

Latin America's likely salience for the United States in the 1990s will derive from its economic impact, the influence of migration, the region's capacity to affect important shared problems, and its significance for promoting core values at the heart of U.S. society.

Economically, Latin America's importance as an export market for the United States could increase sharply in the 1990s if the region can overcome it debt-induced depression and resume the high rates of economic growth it sustained from World War II through the 1970s. The industrial transformation which occurred in Latin American during that period was comparable in scope and pace with that in the United States from 1890-1914, and Latin America's demographic growth has been even more rapid; with approximately the same population as the United States in 1950, Latin America will have nearly twice as many inhabitants as the United States by the end of the century. These facts explain in large measure why Latin America was the fastest growing export market for U.S. products in the late 1970s. U.S. firms still have some comparative advantages in Latin American markets, derived from proximity, familiarity, communication links, financial and other services, and cultural penetration. If Latin American economies can rebound, they could absorb substantially increased U.S. exports. They could also continue to be a significant area for U.S. banking operations, although probably never again at the artificially high levels that were produced in the 1970s when the commercial banks frantically recycled petrodollars in the Western Hemisphere.

Latin America's second and growing importance for the United States derives from massive and sustained migration, especially from Mexico, the Caribbean, and Central America. More than twenty million persons of Hispanic-American descent now live in the United States, and Latinos are this country's fastest growing ethnic or cultural group. More than half the public school students in Los Angeles County and in four southwestern states are of Latino descent. The Salvadoran population of Los Angeles is almost as high as that of San Salvador, and the telephone charges for calls with the United States are reportedly the country's largest earner of foreign exchange. More than ten percent of Central America's population fled the region during the war-torn 1980s, mostly to come to the United States. And the influx from the Caribbean has been relentless since the end of World War II; more than five million people from the Caribbean islands have come to the mainland since then, about one of each eight persons born in the region.

These massive migrations are affecting the United States in myriad ways, shaping education, employment, public health, business, politics, culture, mores, and cuisine. The immigrant communities from Mexico, Central America, and the Caribbean are bound to influence how the United States conceives its stake in the Hemisphere's social, economic, and political conditions and how it relates to the countries of origin. In California, Texas, and Florida -- increasingly important in electoral terms -- voters of Latino and Caribbean origin are already affecting U.S. perceptions and policies.

Latin America is also important for the United States today because of major problems facing this country that cannot be resolved without sustained and intimate cooperation from Western Hemisphere nations. The most dramatic example is narcotics, for Latin American countries produce or transship an estimated 80% of the cocaine and 90% of the marijuana which enters the United States. Although the drug scourge cannot be removed unless demand in the United States is reduced, programs to do so will not succeed without effective programs of crop eradication and interdiction in Bolivia, Colombia, Mexico, and Peru. And there are other vital issues of the 1990s on which Latin



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America's cooperation may well make a critical difference, such as environmental protection; resource development and management, including the provision of secure sources of energy; combatting terrorism; and curbing nuclear proliferation.

Finally, the prospects for preserving values at the core of U.S. society -- particularly respect for fundamental individual human rights -- are significantly affected by conditions throughout the Hemisphere. As a nation committed to freedom, equity, and respect for individual rights, the United States cannot comfortably appear to induce or even to condone repression in a region so historically and culturally connected to our own society, and where U.S. influence has been and remains important. Whenever Latin America's governments base themselves on force rather than on public support, and whenever there are gross and systematic violations of human rights in the Hemisphere, those who take our nation's heritage seriously will always put Latin America back on the U.S. foreign policy agenda.

These four main ways that Latin America will matter for the United States in the 1990s have important implications for the formulation of U.S. policies in the Western Hemisphere.

First, they suggest why the United States should recognize that it has an objective stake in Latin America's economic, social and political realities. In an earlier era, when what mattered to Washington in the Western Hemisphere mainly had to do with military bases, access to materials, the investments of U.S. firms and the diplomatic support of client-state governments, the United States Government could afford to be callous about internal conditions within Latin America, to ignore poverty and inequality, and even to make its peace with repugnant dictators on the grounds that they were "our SOBs." But if what concerns the United States about Latin America is the region's capacity to buy our products and repay loans to our banks, the rate and nature of migration, the prospects for sustained and effective cooperation on tough shared problems like drugs and the environment, and the protection of fundamental human rights --- then the United States should become profoundly interested in the region's internal conditions.

Second, this framework suggests which Latin American countries ought to be of greatest interest to the United States, and why. The relationship with Mexico is of utmost importance, for Mexico scores high on all four dimensions of U.S. concern. Brazil -- a megacountry of nearly 150 million persons and the eighth largest economy in the world -- has little significance for the United States on demographic grounds but is of considerable importance on every other criterion. The Andean countries, at least for a time, will have high salience for Washington because of drugs and related socio-political deterioration, and their spill-over effects on the United States. The Caribbean islands and to some extent the countries of Central America will have an importance beyond their size deriving from the high degree of interpenetration that has been caused by massive and sustained migration, the underlying "Caribbean Basin initiative." Conversely, when it weighs its real contemporary interests, Washington should understand that it has much less at stake in the outcome of Central America's civil wars than has been repeatedly affirmed in recent years.

Third, the issues at the heart of United States-Latin American relations in the 1990s will increasingly be "intermestic"; ie. involving both international and domestic aspects and actors. Trade, immigration, narcotics control, resource development, and environmental protection will all require complex management, involving the active participation not only of many executive departments but also of Congress, of state and local authorities, and of nongovernmental organizations. The line between domestic policy and Latin American policy will be consequently hard to define.

Fourth, contrary to the newest conventional wisdom inside the Beltway, Latin America will be of heightened relative importance for the United States. For those who have seen the world almost exclusively in Cold War terms, the events of 1989 have made Latin America now seem virtually irrelevant, likely to "fall off the map" of U.S. concerns. But as U.S. interests and energies turn inward to challenges like controlling drugs, assuring adequate and secure sources of energy, protecting the environment, and assimilating new waves of immigrants, Latin America may well be increasingly salient.

To conclude -- Latin America's chances for economic growth, social equality, political stability, continued democratic opening and respect for human rights all depend to a significant extent on substantial regional debt relief.

The interests of the United States are deeply engaged in Latin America's prospects for renewed growth, social equality, and democratic consolidation.

For these reasons, Mr. Chairman, the Senate and the U.S. Government in general should, with some urgency, be seeking ways to help assure a broader and more rapid alleviation of Latin America's debt burdens.

Chicago Tribune

8 Section 1 Monday, July 17, 1989

# How to improve on the Brady plan

By Peter Hakim

Even if they finally produce an agreement, the extended debt reduction negotiations between Mexico and its commercial bank creditors have made one thing clear: The banks do not want to play their assigned role in the new U.S. approach to Latin America's debt problems.

What has also become evident is that the script laid out by Treasury Secretary Nicholas Brady is flawed. The so-called Brady plan does not provide sufficient motivation or direction to resolve the debt crisis, nor does it adequately protect the public resources being called upon to support debt relief.

When the plan was announced on March 10, it was widely applauded, and rightly so. Washington seemed at long last to have faced up to three crucial facts about the debt crisis:

- The massively indebted countries of Latin America and elsewhere could not hope to restore sustained and adequate growth to their economies and, at the same time, continue to pay their full debt obligations.
- The commercial banks had to reduce sharply their outstanding claims on these countries.
- The banks would not accept reduced debt payments unless the United States and other industrial country governments were prepared to use public resources to offer some guarantees—directly or through international financial institutions—that the claims remaining after the reduction operation would be paid.

These ideas are right. The question is whether they will be implemented. The trouble with the Brady plan is that it is completely voluntary. Each creditor bank has the choice of whether to participate in debt reduction, how much reduction to offer, and how to offer it. Indications are that if the banks have their way, they are not going to provide much real relief to the countries.

What is required to make the Brady plan work is to make it less voluntary.

First, the amount of debt reduction offered to a country should be determined not by the commercial banks but by the World Bank and the International Monetary Fund, the two institutions that will be putting up most of the resources to support debt relief. Indeed, the Bank and the IMF have already calculated the capacity of most countries to repay their commercial loans. Those figures should be put to use.

No debt reduction operation supported by public resources should leave a country with a level of indebtedness that it cannot reasonably be expected to pay back. Not only will the country's growth continue to be constrained by excessive debt, but public resources will be put at risk unnecessarily.

The World Bank and IMF, in short, should not guarantee debt payments of any country unless that country is judged to have the capacity to make good on those payments—thus leaving little chance that the guarantees will ever be called. In practice, this also means guarantees should not be made available until virtually all banks with loans to a country agree to participate in the reduction effort, and until the country firmly commits itself to growth-oriented economic reforms.

Second, the resources provided for debt reduction, because they are necessarily limited, must be used efficiently. The current plan is for countries to employ World Bank and IMF resources mostly to buy back commercial loans at discounted values; this is the most expensive and least efficient way to achieve debt relief, regardless of how deep a discount is offered.

Take Mexico, for example. It owes about $60 billion to commercial banks and pays them $6 billion to $7 billion a year in interest. If the World Bank and IMF were to determine that Mexico can pay only $3 billion a year (which is close to the actual number), it would take some $30 billion up front to repurchase sufficient debt to reduce Mexico's payments to the target amount. That $30 billion is more than the total set aside for debt reduction worldwide over the next three years.

There is a cheaper way. The World Bank and IMF could set up a reserve pool that would be used to guarantee Mexico's interest payments (at the reduced level of $3 billion yearly) as well as those of other countries qualifying for debt reduction. Just as group insurance is far cheaper that individual coverage, the pooling of guarantees would be less costly than transferring funds directly to the debtor countries. Only a small amount of resources would be needed at the outset to establish such a pool; the rest would be callable capital—to be drawn upon only if a country fails to meet its reduced obligations.

Moreover, rather than fixing Mexico's interest payments once and for all, these could be tied to the price of petroleum (or to the weighted average price of all Mexican exports). Bank creditors would share in windfall gains if Mexican exports increased in value, while Mexico—and the public resources used to guarantee Mexican debt payments—would be protected against steep declines in the country's income.

Finally, the Brady initiative cannot continue to rely entirely on the "carrot" of guarantees to induce commercial bank participation in debt reduction. Some sanctions for nonparticipation are necessary. In the absence of an international bankruptcy court, there is probably no way to force commercial banks in the United States or elsewhere to reduce their debts by a determined amount. But U.S. and other creditor governments should not allow the banks to carry Latin American loans on their books at full face value. Commercial banks should be required to end that fiction and write down all their loans to a country to the amount the IMF and World Bank determine the country can pay—and create a corresponding loan-loss reserve. Banks would have to pay some price for their unwillingness to negotiate adequate reduction. This sanction also would create some intramural pressure among banks.

*Peter Hakim is staff director of the Inter-American Dialogue in Washington.*

Los Angeles Times

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# *First of All, Slash Away the Old Debt*

**■ Latin America:** As in bankruptcy, let a third party determine just how much of the region's obligations really should be paid.

By PETER HAKIM

Frustrated by the slow implementation of Treasury Secretary Nicholas F. Brady's new debt strategy for Latin American, President Bush recently appealed to commercial bankers for support. But the President's appeal is not likely to produce much action—at least not until the objectives of the Brady strategy are clarified and some teeth are added to it.

The first thing Brady should do is decide whether he wants the banks to provide new loans to Latin America or to significantly reduce their debt claims. The banks would prefer not to do either; they will certainly not do both.

The fact is that new borrowing makes no sense for most Latin American countries. They are saddled with huge, unpayable debts and should not be adding more. Piling new debt on old is simply postponing the day of reckoning, not solving the problem.

Indeed, the great majority of Latin American nations have already stopped paying interest on their commercial loans. Of 19 Latin American countries, only four—Mexico, Chile, Uruguay and Colombia—are current on interest payments. Thirteen have failed to service their debts for more than a year, and Brazil and Venezuela have also fallen into arrears. New money will not help these countries. It will be used for back-interest payments, not to finance investment.

Why should banks make new loans when their old loans are not being repaid and are now worth only a fraction of their face value? This has kept the banks from lending to most of Latin America for the past four years. Since 1986, only Brazil, Mexico and Argentina have obtained any significant commercial credit. A year ago, Brazil received the last major package of loans. Brazil never touched the money; it went to cover interest accumulated during a year-long payment moratorium.

Banks do not want to lend to any Latin American country, whether it is repaying or not. For seven years, Mexico has paid every dollar of interest on time and has undertaken wide-ranging economic reforms. Yet no bank is prepared to voluntarily lend to Mexico. Colombia, the only country that has regularly repaid principal and interest, has not been granted new financing.

As one bank official said: "It is largely futile . . . to expect significant future participation by banks in loans of maturity over one year." In short: Latin America should not count on commercial banks for any more large-scale capital inflows. Several American banks recently reinforced that message by expanding their reserves against losses from Latin American loans.

Latin America cannot regain access to commercial credit until its economic performance eliminates the risk of non-payment. That is why debt reduction is vital. By contributing to economic recovery, debt reduction is more rather than less likely to lead to renewed bank lending. Latin American countries will be considered credit-worthy not because they have paid off past loans but because bank officials have been persuaded that they can repay new loans.

But the banks have shown no more willingness to reduce their Latin American debt holdings than they have to provide new loans. What is needed to resolve the debt crisis is something akin to international bankruptcy proceedings. A third party—not the banks or countries—should decide how much of the debt should be paid.

Those countries prepared to pursue sound market-oriented economic policies should have their debt obligations cut back to a level that they can afford to pay—that is, a level consistent with their longer-term growth needs. For half or more of the countries of Latin America, that means virtually wiping out their debts. Anything less will simply prolong the debt crisis.

*Peter Hakim, staff director of Inter-American Dialogue, writes frequently on issues in the Western Hemisphere.*

**Latin America Enters the 1990s**

by Abraham F. Lowenthal*

As the 1990s begin, history seems to be accelerating. Breath-taking change is occurring in many parts of the world and in many realms. Technological developments in computers, lasers, genetic engineering, fiber optics, and superconductivity are beginning to reshape the world's economy. The striking triumph of democratic politics and market economics has brought on talk of the "end of history," or at least of the Cold War as the organizing concept of international relations.

In many world regions, rapid progress is being registered. Perestroika and glasnost are transforming the Soviet Union and Eastern Europe. Western Europe is moving quickly toward enhanced economic integration. Japan is taking its place as a major world power.

Even some of the world's most intractable problems appear to be more open to eventual solutions. Conversations have finally begun between South Africa's white minority government and black nationalist leaders. Slowly but inexorably, Israel and the Palestinians seem to be groping toward eventual compromise. In China, where 1989 saw such wrenching setbacks, one senses nonetheless that the tide of history is running toward modernization and eventual opening.

It is hard to be so optimistic, however, about Latin America and the Caribbean. After a "Lost Decade" of recession, Latin America enters the 1990s in deep trouble. Economic and social conditions are desperate in many countries, and political tensions are rising.

Just ten years ago, both the facts and the mood were very different. Latin America as a whole was still then enjoying the final glow of a prolonged period of rapid economic growth. From 1950 through 1979, the region's annual rate of growth was twice that of the United States and most other OECD nations, and faster than that of all developing countries except for a very few in East Asia. In some countries -- Brazil and Mexico, in particular -- a generation-long drive to industrialize had produced a transformation equivalent in scope to that which occurred in the United States from 1890 to 1914. And Latin America's politics, a decade ago, were just entering a period of hopeful transitions from authoritarian rule toward democracy.

* This essay has been prepared for publication in the Spring issue of the Harvard International Review. ©Abraham F. Lowenthal.

For Latin America as a whole, the 1980s did see political opening, but also economic disaster. These past ten years saw the return of democratic politics to all the nations of South America, culminating in the last month of the decade with the first direct presidential elections since 1960 in Brazil and since 1970 in Chile. Peaceful transfers of power from incumbents to opposition movements took place during the 1980s in countries as diverse as Argentina, Bolivia, Ecuador, Peru, and Uruguay -- in some cases the first such democratic transitions in memory. Movement toward participatory or at least electoral politics, though less inclusionary or robust, also took hold in several nations of Central America and the Caribbean. Mexico, after 60 years of one-party rule, had its most competitive and meaningful elections in history in 1988 and appears on its way, albeit by fits and starts, toward pluralist politics. At the beginning of the 1990s, Cuba is the only country in the Hemisphere openly defying the regional commitment to democracy (although Guyana and Haiti are still far from embracing the commitment).

But while the peoples of the Americas took satisfaction from the expansion of participatory politics, most countries also faced a painful contraction of economic performance. Latin America suffered a nearly 10% regional decline in per capita income, and a far more severe drop in some countries and sub-regions. Unemployment and underemployment are high, inflation plagues many nations and hyperinflation is ravaging a few, and socioeconomic inequalities are almost everywhere getting worse. Latin America's share of world commerce fell during the 1980s from about 6% to 3.5%. Its terms of trade worsened markedly, with a decline in the real value of almost all its commodity exports.

Latin America's nearly $420 billion external debt -- itself in part a result of the recognition by financial markets of the region's growth and potential during the 1970s -- caused a massive drain of capital, amounting to about $200 billion from 1982 through 1989. Latin American nations have had to drastically curtail imports, cut social services, and reduce investments in order to service their debts. They have been caught on a treadmill, mortgaging their future in futile efforts to clear their accounts.

Translated into human terms, the statistics on Latin America's plight mean hunger, infant death, boat people and feet people, stunted education, epidemics, street crime and delinquency, and mounting despair. The political residue of the 1980s, in turn, is overwhelming repudiation of incumbent governments in almost every election; increasing political polarization in many nations; incipient questioning of the democratic framework in several; and growing insurgencies and terrorist violence in a few.

At the beginning of the 1990s, five broad regional trends deserve special emphasis.

First, throughout Latin America and the Caribbean, the cumulative effects of the Lost Decade are becoming evident. Latin America's industrial infrastructure is eroding, the results of curtailed investments in education and research are beginning to be felt, social and health problems are mounting, and there is almost everywhere a sense of urgent crisis. It is widely recognized that most of Latin America cannot count on significant external capital during the 1990s -- that neither renewed foreign investments nor new commercial lending are likely to enter the region on a broad scale.

It appears increasingly improbable that the debt crisis of the 1980s will ever be "resolved" with a clear and comprehensive solution; it will more likely be managed, on a case by case basis, on terms that reflect the divergent interests and relative strengths of the various actors and that consequently leave most Latin American nations bereft. Small regional banks in the United States, as well as many European and Japanese banks, are simply withdrawing from the region, cutting their loses. Large money-center banks are grudgingly reducing their expectations and are wary of new or expanded involvements. Latin American nations are bargaining individually to reduce their severe burdens at the lowest cost in terms of future economic possibilities, but it may turn out that few, if any, will be positively helped to achieve the new economic expansion that could provide the only real escape from the debt trap. The very difficult challenge faced by countries throughout the region is how to design economic development strategies that can mobilize domestic savings and reattract flight capital without counting on external capital and without aggravating socio-economic inequalities and tensions. Without international assistance, this challenge may be overwhelming for many Latin American nations.

Second, the exhilarating progress of democratic opening throughout Latin America is giving way to preoccupation with issues of governance and governability. It is hard for fragile democratic regimes to meet the challenges posed by economic decline, particularly when that is accompanied by prolonged insurgencies, the narcotics traffic, rampant corruption, increasing labor unrest, and widespread disillusion and disaffection. After several years of strong reinforcement of Latin America's moderate center -- as part of the process of abertura -- much of the region seems now to be entering a renewed phase of polarization. Both leftist and rightist (or neo-conservative) groups and leaders are gaining greater strength, sometimes in the same countries.

Third, much of Latin America and the Caribbean -- from Argentina to Mexico -- is experiencing growing tension between the processes and consequences of political and economic liberalization, between opening politics and opening markets. In the United States, it is widely assumed that market economics and democratic politics necessarily accompany and reinforce each other; the parallel moves in the late 1980s toward democratic opening and liberal economic reforms in Latin America seemed to support this view. But the impressive strength in the late 1980s of Cardenas in Mexico, Lula in Brazil, the Frente Amplio and Nuevo Espacio in Uruguay, and of MAS and Causa R in Venezuela raise serious questions -- a bit different in each case -- as to whether more democratic participation may eventually spawn renewed populist, statist, and possibly nationalist approaches and policies early in the early 1990s, and whether the emergence of such challenges may produce moves to restrict democratic competition. Throughout the region, too, there are serious concerns as to whether the choices made by political actors in order to ensure the survivability of fragile democracies may make it less likely for democratic regimes to confront the fundamental problems of poverty and gross inequality. In their effort to build commitment to democracy by the business and military groups which undermined it in the 1960s and 70s, democratic politicians in several countries made compromises that protect various entrenched privileges, but these restrictions may make democracies harder to sustain, and they may interfere with some of the reforms needed to foster sustainable economic development.

Fourth, the differences among the countries and subregions of Latin America and the Caribbean -- always much greater than most North American policy analysis or public discussion assume -- are becoming more pronounced than ever:

-- Mexico and many of the islands of the Caribbean are silently integrating with the United States, in the sense that their economies are ever more closely intertwined with ours, and their people are migrating to this country at an accelerated rate. Mexico, in particular, seems embarked on a course of policy that, if sustained over time, may make it increasingly a North American nation, ever more different and removed from Latin America.

-- Peru and to a lesser extent Colombia, on the other hand, are showing worrisome signs of disintegration, with whole regions of each country under the control of insurgent movements, counter-insurgent paramilitary groups and/or drug traffickers, and with the legitimacy and authority of the central national government ever more precarious.

-- Central America, the focal point of so much struggle during the 1980s, is now poised uncertainly between the possibility of peace through utter exhaustion, the prospect of renewed and more violent confrontation, or years more of low-level but deadly conflict. The FMLN offensive in El Salvador clarified that battered country's real options -- another generation of brutal war or else a negotiated peace that satisfies neither the country's establishment nor its insurgents. Guatemala's civil war simmers, ready to erupt again. Nicaragua faces, at best, a decade of painful reconciliation and slow reconstruction, and no one can exclude the possibility of further violence and repression there. Panama now confronts the very tall tasks of rebuilding public order, reconstructing the institutions of national self-government, and reviving a devastated economy.

-- Cuba, important beyond its size in Latin America and inter-American affairs during the past generation, is receding in relevance. Isolated from Latin American political currents by its continued caudillo rule and virtually unique in the "Socialist" world because of its forthright rejection of the Gorbachev reforms, Cuba seems caught in a time-warp, reflecting the conditions and concerns of the 1960s more than those of the 1990s.

-- Argentina, Brazil, and to some extent Venezuela are internally divided, with growing uncertainty and the possibility of quick policy reversals and even of turbulence in each case. In all three countries, proponents of market-oriented orthodoxy have dominant influence at the moment, but in each case those who espouse neopopulist heterodox formulas are strong contenders for power. In Argentina and Venezuela, charismatic political leaders Carlos Menem and Carlos Andres Perez on taking office quickly moved away from their natural populist constituencies to embrace anti-statist approaches; it would not be altogether surprising if the newly-elected conservative president Fernando Collor de Mello in Brazil, who campaigned on a broad anti-statist platform, made something of a reverse switch in 1990 in an attempt to divide the massive following his leftist rival galvanized in last December's election. In none of these three countries is it at all certain what policy approaches will prevail in the next two or three years, or even whether the established political rules will survive.

-- Chile and Uruguay, meanwhile, enter the 1990s in relatively strong shape, as each enjoys the fruits of restored democratic politics and, in the case of Chile, of a newly modernized economy. Each country is regaining its erstwhile place as a bastion of civility and a forum for intelligent and critical political debate. Each nation has the benefit of a matured left, unlikely to repeat the excesses of the late 1960s and early 1970s that led to authoritarian repression, and of a pragmatic right, chastened by the popular repudiation of military rule. In each country, however, the moderate centrists who hold power as the decade begins may soon face challenges from both sides that will make it difficult to retain simultaneously business confidence and broad popular support.

Fifth, even if there are strong reasons for concern about Latin America's immediate future, it is also important to stress some reasons for longer term optimism about the region's overall prospects. Declining fertility rates throughout most of Latin America augur well for an improving balance between resources and population, and between economic growth and expansion of the labor market. The structural reforms already undertaken in several countries increase the likelihood that Latin America, or at least part of the region, will eventually be able to insert itself more fruitfully into the evolving world economy. Even during the 1980s, the region's exports expanded over 50% by volume. A generation of urbanization and expanded education has modernized Latin America and greatly improved the capacity of its citizens. In many countries, grass-roots and popular organizations are gaining vibrant strength unprecedented in Latin America's history. And the regional commitment to human rights and democratic politics, however fragile, is also noteworthy; many Latin American countries may finally escape the syndrome of repeated military interventions.

With all that is happening in Latin America -- and with the dramatic shifts in the overall global context -- it is predictable that United States-Latin American relations will also be reshaped. After a decade of obsessive focus on Nicaragua and a year of misplaced preoccupation with Panama leading to the invasion of December 1989, Washington may finally be ready in the 1990s to redirect its concerns, away from Central America. But it is by no means clear whether Washington will now focus on the nations of the Western Hemisphere where tangible U.S. interests are most directly affected, or whether the United States will instead revert to pervasive neglect of Latin America.

With the Cold War ending, Latin America (or at least some of its subregions) may come to be recognized as increasingly significant to the United States. Mexico, a nation of 85 million persons right on the border of the United States, affects the daily lives of people in the United States as much as any other nation in the world. Brazil, a mega-country of some 150 million persons, is already a major economic actor with considerable political influence and potential. The Andean nations, because of the drug traffic and because of their expanding internal convulsions, are bound to have a large impact upon the United States. So will the small islands of the Caribbean -- because of their extraordinary interpenetration with this country through migration, tourism, trade and investment. If the foreign policy leadership of the United States takes heed of the primary concerns of its citizens, it will turn increasingly from questions of national security (and national insecurity) to such problems as drugs, migration, trade, and environmental protection.

If and when these "intermestic" issues -- partaking of both international and domestic components and involving both foreign and domestic actors and decision-making processes -- become central to U.S. foreign policy, the United States may finally turn to building effective partnerships with its neighbors in the Americas. But it is also possible that a stagnating Latin America will be left instead without partners, increasingly marginal in a dynamic post-Malta world that has left it behind. As the 1990s open, it is by no means clear which path is more likely.

Abraham F. Lowenthal is a professor of international relations at the University of Southern California and executive director of the Inter-American Dialogue, a Washington-based conclave of Western Hemisphere leaders. His most recent book is Partners in Conflict: The United States and Latin America, (John Hopkins University Press).

Senator SARBANES. Thank you very much. It's a very helpful statement.

Professor Weintraub.

**STATEMENT OF SIDNEY WEINTRAUB, DEAN RUSK PROFESSOR, LBJ SCHOOL OF PUBLIC AFFAIRS, UNIVERSITY OF TEXAS, AUSTIN, TX**

Mr. WEINTRAUB. Thank you, Mr. Chairman.

The time is quite limited and others have provided a good deal of the details of the Mexican agreement and some of the other agreements, particularly the importance of providing options in the debt discussions. I won't repeat these even though I have some of those details in my prepared statement.

I will try to provide the Mexican context, both in terms of analysis of Mexico as a basis for the discussion which follows, and also as to what example the Mexican case has for other countries elsewhere in Latin America. In the process, I will comment on some of the points made by others in response to questions.

The biggest imperative that Latin American countries face, I think, and this is particularly true in Mexico, is the restoration of economic growth after the disastrous decade of the 1980's. You have the figures others have cited in front of you. In Mexico, real wages went down since 1982 by about 50 percent. They were cut in half. Just stop to think what real wage cut in half would be if we had to face something similar in our own country. Per capita declines in income were in the neighborhood of 15 to 20 percent. As an aside, in response to questions Senator Graham asked earlier, these declines in per capita and overall incomes had disastrous consequences for U.S. exports.

Secretary Mulford made the point that our exports are now beginning to catch up to what they were and that's true in Mexico. It's not necessarily true elsewhere, but in any event we've lost all of the growth that would have taken place during all of that period and that's been a major contribution to our trade deficit. Probably about a third of our trade deficit can be explained by the fact that Latin America was unable to grow during all of the period of the 1980's.

Several witnesses made the point that debt relief is useful when made in the context of structural adjustments by the countries themselves. I agree very much with that comment.

In the case of Mexico, the adjustments have been quite remarkable. I won't go into too much detail but I will mention some of the adjustments that the Mexicans have made in their economy.

Until the early 1980's, you could not export to Mexico without permission from the authorities, and a license would not be granted if that product was produced in Mexico. The Mexican economy is now open. There are still a few areas where there are some controls, but they represent a declining proportion of the economy.

Mexico's tariffs now average about 9 percent. That's almost in our league, not quite there, but Mexico is getting to that particular point.

When oil prices collapsed in the early 1980's, Mexico made a determined effort to increase its exports of nonoil products, particu-

larly manufactured goods. They did this in conjunction with lowering duties.

This particular aspect of Mexican trade and production is closely linked to the United States. About 85 percent of all manufactured goods exported from Mexico comes to the United States. About half of those exports take place between related parties, the parent and a subsidiary. In other words, we can call it a foreign country if you want, but the linkages are very deep and that must be kept in mind.

Mexico has gone through a tremendous deregulation of its economy. The trucking industry in Mexico has just been deregulated. Company after company is being privatized or closed. A big steel mill in Monterrey was closed, several airlines were sold. In other words, almost any witness of the Mexican scene would say that the transformation that has occurred has been breathtaking and would have been unthinkable 10 years ago.

Let me now return to the point I made earlier, that I think the imperative for Mexico, as for other Latin American countries, is economic growth, economic growth that's durable because of a restructured economy. I just said that Mexico has restructured. The contribution of the debt settlement to Mexico in interest payments foregone is about $1½ billion a year. It's a little bit more in the first year because of some retroactivity. This is about 1 percent of Mexico's GDP, gross domestic product. Mexico's interest burden in the past has ranged between 6 and 8 percent of its gross domestic product and this debt relief provides 1 percent of GDP.

It's a significant amount, but it's by no means crucial in terms of Mexico's economy.

As an aside, let me make one other point. Several of the witnesses pointed out that Mexico's internal debt is greater than Mexico's external debt—not the debt, but the service on the debt. That's true, and I will come back to that point.

But it's true in large part because in order to keep capital from flowing out of Mexico, the authorities have kept real interest rates in the neighborhood of 30 to 35 percent and this accounts for much of the capital flow that came back to Mexico during last year and it also accounts for the very high service costs on internal debt. I've heard the Mexican authorities talk about the need to cut back the budget hoping to get about 5 percent of GDP in the cutbacks. One percent of that will come from debt. They hope to get 2 additional percent from privatization, that is, 2 percent less money they would have to spend in the budget, and then 2 additional percent from tax collection. This would bring the internal deficit down to manageable proportions and at the same time reduce the burden of internal debt.

The importance then of the debt agreement with the banks is not in the immediate relief—there will be some long-term relief—but in the expectations that it sets up in the minds of foreign investors and the Mexicans to encourage investment in the expectation that Mexico will be recuperating. Several of the witnesses made this point. Much of the same is true in the other countries where debt relief has taken place.

Another imperative is for restoration of capital inflows into Mexico. This point was made by Bill Rhodes and I think quite cor-

rectly. Secretary Mulford said that there was some restoration of capital inflow last year. Not too much emphasis should be placed on that reflow because Mexico cannot recover if it keeps real interest rates at 30 or 35 percent, and this high rate stimulated the inflow. The real interest will have to start going down pretty soon.

I wish to praise Secretary Brady and the people in the Treasury for working out a plan which has really provided debt relief. There was a recognition that new capital was not going to flow in and I think the Brady plan was a courageous step and extremely useful step, even we don't know how far it will go to deal with the debt problem.

At the same time, the plan has permitted most banks to withdraw from Mexico precisely at the critical moment that Mexico needs new money. This is the reality. I will come back to this point in a minute. Several of the witnesses made this point.

Is the Brady plan a model for other countries? I don't think it can be a template or a cookie cutter—others have made this point—but it has had the desirable effect of forcing banks to think in terms of debt relief as one necessary element.

However, the shortcoming is that no other country has thus far taken as complete steps as Mexico in its adjustment process. Maybe Brazil will under President Collor. I don't know. And even Mexico was unable to raise very much new money under the debt agreement, despite all of the enhancements.

As you look ahead for the rest of this year, the situation in Mexico is really quite delicate Mexico is keeping its inflation down. It's about 20 percent a year now. The authorities are keeping inflation down by what they call a pact among industry, government and labor. In effect, it's a form of incomes policy which Mexico is following and the country has to come out of this pact at some point. They have to come out of it probably by the middle of this year and we don't know what effect this will have on the value of the peso, what the effect will be on the growth of inflation, but most important, we don't know what the effect will be on expectations.

The reason I make this point is that at this critical juncture very little new money is coming into Mexico. There isn't very much new investment coming into Mexico now other than the working out of some of the earlier debt-equity swaps. Flight capital has been attracted back largely by high interest rates and I just finished saying they are not durable.

Therefore, I think some source of new funds is going to be needed. New funds are also going to be needed for the other countries going through their debt problems. I hope that Peter McPherson is right that more new money will go into Venezuela than was opted by the banks for in Mexico.

Let me conclude I am quite optimistic about Mexico, relatively so about Venezuela, and there's some reason to be so about Brazil based on some things that have been said during this hearing.

If in fact Mexico starts growing again, the investors will return. Indeed, the bankers will also return. If there's some way to make money, they will come back again despite the debt rescheduling. If Mexico starts growing again, much flight capital will also return.

But there is a real chicken and egg problem. Mexico needs new capital to grow and it's only after Mexico start growing that this capital is going to come back.

What do I conclude? I agree with what Bill Rhodes said, that we really do need some coordinated action by the international financial institutions, the World Bank, the Inter-American Bank, the IMF, by the export credit agencies of the world, by the commercial banks, and I think also by the U.S. Government in Mexico and in other places.

Thank you very much.

[The complete prepared statement of Sidney Weintraub follows:]

Subcommittee on International Finance and Monetary
Policy, Senate Banking Committee
March 21, 1990

Statement by Sidney Weintraub
Distinguished Visiting Scholar, Center for Strategic
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Dean Rusk Professor, Lyndon B. Johnson School of Public Affairs
University of Texas at Austin

# Mexico's Place in Third World Debt Strategy

Mr. Chairman and members of the subcommittee:

A debt rescheduling should not be viewed in isolation from the total context in which it takes place. Thus, the benefit to Mexico from the debt agreement signed with commercial banks on February 4, 1990 can be assessed properly only in time, after we see its contribution to the economic recovery of the country. The agreement has some immediate benefits - the reduction of annual interest payments equal to about 1 percent of Mexico's gross domestic product (GDP). It will have longer term value in reducing the stock of Mexico's debt to foreign banks. But its ultimate evaluation will depend on the confidence it instills among investors, both foreign and domestic, and how this plays back on Mexico's recovery from a tragic economic decade.

I would like, briefly, to set the situation. In terms of overall economic growth, Mexico was one of the world's premier performers for some fifty years, from the 1930s until the start of the 1980s. Annual economic growth over this period averaged between 6 and 7 percent. Despite high rates of population growth, reaching 3.5 percent a year, this left room for per capita growth in GDP of around 3 percent a year. This is more

than was achieved in the United States for most of its history. The main engine of growth was the internal market, growth made possible by a stable political system, modest inflation, and prudent borrowing internally to finance the public sector deficit and externally to deal with the manageable deficit in the current account of the balance of payments.

The structure collapsed in 1982. The proximate cause was the decline in oil prices, which in that year made up 78 percent of the value of Mexico's exports. However, this was not the only reason - the entire foundation on which economic policy was based was weak. The country was keeping its GDP growth rate high during the late 1970s and early 1980s on the basis of debt buildup. In 1981 alone, debt grew by more than $23 billion. To get some grasp of the dimensions of this figure, it would be equivalent to external U.S. borrowings of more than $750 billion based on the GDP relationships of the two countries. When Mexico started the debt renegotiation decade by letting its creditors know in August 1982 that there was no cash in the till, its external debt was about $85 billion, more than ten times what it had been ten years earlier.

The other underlying cause of the economic collapse was the lack of competitiveness of Mexico's industrial structure which had been developed in a hothouse atmosphere of protection. This lack of external competitiveness combined with the saturation of the internal market that had been the engine of growth.

Keep in mind what this mixture of factors involved: a

drastic decline in the price of oil, which by then was the bulwark of Mexico's foreign exchange earnings; an external debt that had mushroomed and could not be serviced; a large internal debt stimulated by growing public sector deficits over the previous decade; and a policy of looking inward as the stimulus for economic growth which had long since run its course.

What were the economic policy options available to the government? I am now coming to the end of these introductory comments, which I think are necessary to understand the context of Mexico's repeated debt reschedulings of the 1980s, of which the agreement signed last month was the latest episode.

One option open to Mexico was to repudiate its foreign debt, or less drastically, declare a moratorium on servicing it until the economic situation improved. This option was rejected as being too costly in the sense that it would cut Mexico off from further external financing. However, once the decision was made to service the debt - a rescheduled debt, to be sure, because there was no foreign exchange to pay the debt as originally contracted - this implied correlative economic changes. One of these was to shift the main engine of growth from looking inward to expanding outward, to base economic policy on expanding exports. These larger exports could not be oil - the price had fallen drastically. They could not be agricultural products, whose production Mexico had neglected in its drive to industrialize. They had to be manufactured goods. In the period since 1982, and especially since 1985, Mexico has transformed

itself from a largely closed economy with high import barriers to an open economy with import duties not markedly higher than those of many industrial countries. Mexico's average tariff today, weighted by imports, is around 9 to 10 percent.

The option to pay debt also required getting the resources from the domestic economy. Interest payments to foreign creditors have been between 5 and 6 percent of GDP a year in recent years, around $8 to $10 billion a year in absolute terms. Resources dedicated to service external debt are obviously not available for use to stimulate economic growth in the domestic economy. In practical terms, Mexico had to impoverish itself - to delay economic recovery - to service its external debt.

Bankers would quarrel with this statement - I know this from discussions with them. A country, they argue, can grow out of the large burden of external debt by reducing the size of the debt relative to the total economy. South Korea, despite a large external debt, has been doing this through substantial overall economic growth. But there is a major difference between the two countries in that Mexico was simultaneously forced to restructure its economy away from dependence on oil, whereas South Korea had begun its structural adjustment stressing manufactured exports much earlier. In time, Mexico should be able to grow out of the large burden that servicing the external debt involves, but the transitional hardships cannot be erased by some abstract model that omits time - the time needed to restructure the economy to permit it to achieve sustained growth.

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The economic hardships endured by Mexicans during the 1980s were real - indeed, all too harsh. Real wages - wages adjusted for inflation - declined by 50 percent between 1980 (or 1982) and now. Per capita income as a whole - from wages, profits, professional incomes, rents - fell by more than 15 percent. Many Mexicans made ends meet by holding two jobs - I have friends who hold three. Others hustle for the necessities of life in the informal or underground market - fortunately so, because without this the social structure of the country would have suffered grievous damage. The strong showing of the political left in the presidential elections of 1988 were in large part a reaction to the hardships imposed on the population.

Those who argue that countries can grow out of the burdens of debt servicing are undoubtedly correct -they can point to countries in which this has been done - but in Mexico the fact was that the burden was met on the backs of the population. Those who suffered most were at the lower end of the income distribution pattern - they have long borne the brunt of Mexico's economic policies. The Baker plan for dealing with international debt eventually did not succeed, but it had the virtue of seeking to solve debt problems through growth rather than by economic decline. It did not work because the external resources necessary to bring about this growth were not there. My own view is that the Baker plan had the right overall philosophy, but did not take adequate account of the devil that lurked in its details.

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I would like now to turn to the Brady plan and how it has worked in Mexico. I, for one, applaud Secretary Brady and those who worked with him for taking an initiative that recognized the need for some debt relief. The Brady plan had two features that I would like to highlight. One was familiar from the Baker plan, that debt issues are best resolved in an atmosphere of economic growth and not of decline. The second feature is that debt restructuring really requires relief - some easing of the annual debt service burden. The Baker plan relied solely on new money from banks and international institutions - that is, on a further debt buildup justified on the grounds that economic growth would reduce the relative size of the debt in relation to GDP or to exports of goods and services. The Brady plan has this element as well, but it is accompanied by actual reductions in either debt principal or the interest rate. It was these two features - real relief alongside new money - that commercial bankers had long resisted and which the Brady plan pushed them into doing. Whatever the shortcomings of the Brady plan outcomes - and I will cite some - I believe that its authors deserve credit for tackling a difficult issue in a more realistic way than had been done before. The devil in the details were not fully overcome, as I shall indicate, but they were not completely ignored.

The broad features of the 1990 debt agreement with foreign commercial banks were the following. The agreement covers some $48 billion, or about 85 percent of Mexico's debt with the banks. Banks had three choices. The first was to exchange existing debt

for long-term bonds valued at 65 percent of the face value of old debt. Some 41 percent of the old debt was transformed under this option. The second option, to reduce the interest rate on old debt to 6.25 percent, was chosen by banks to cover some 47 percent of the debt. The third option chosen by banks, to provide new money over four years equal to 25 percent of outstanding credits, covers 12 percent of the old debt.

Two other features of the rescheduling merit note. One is the so-called enhancements of $7 billion to be used to buy 30-year, zero-coupon bonds as collateral for the new bonds and to assure two years of interest servicing. Funds for the enhancement come from Mexico itself, Japan, the World Bank, and the International Monetary Fund. A second feature was the inclusion of debt-equity swaps of up to $3.5 billion over the period January 1990 through June 1993. Mexico had suspended an earlier debt-equity swap program and consented, in the new agreement, to renew these for banks participating in the rescheduling.

Looking at the agreement only as it affects debt - that is, omitting for now its broader implications - there clearly were achievements for Mexico. Annual interest costs will decline by about $1.5 billion compared with the pre-agreement situation. Reduction of the principal outstanding - from the banks that chose the first option - will be about $7 billion.

Looking at the total system for dealing with the debt burden, the agreement with Mexico had some non-trivial

accomplishments. The United States government took an important initiative, the Japanese government responded to support the enhancement package, and the international institutions, the World Bank and the IMF, contributed positively to the outcome. As was evident from press accounts, bank creditors around the world were generally less than entranced by being pressured into reducing principal and interest on outstanding debt, but in the end they responded. The Mexican authorities had hoped for more - for annual interest payment reductions of 2 to 4 percent of GDP and no obligation to undertake further debt-equity swaps - but any agreement of this type must involve compromises.

I used the lukewarm word "non-trivial" to describe the cooperative achievement. This reflects my admiration for what was done in a difficult negotiation, combined with my concern that the hype exceeded the accomplishment. It is not clear how many future agreements of this type, each with some enhancement package, are feasible, given creditor bank resistance and stringent national and international budgets. In other words, I am not sure that Brady will turn out to be a viable model for Argentina, Brazil, the Philippines, Venezuela, and others who are either negotiating now or who soon will be seeking debt relief.

Mexico was a model debtor. It began a painful process of structural adjustment well in advance of the most recent debt negotiation. For persons who have followed the Mexican political-economic scene for any time, the changes of the last eight years are breathtaking. A closed economy was opened.

Major government-owned enterprises are being sold. Inflation has been brought down from more than 150 percent a year to a current rate closer to 20 percent. The exchange rate was sharply devalued to encourage exports. An economy dependent on petroleum now obtains more than half its export earnings from manufactured goods.

Mexico chose to bear the burden of meeting its debt obligation based on the judgment that this would be less costly in the long run than de facto repudiation. This eschewing of populist politiquería has been costly.

I mention these points because, despite them, the debt negotiation was most difficult. In none of the other countries mentioned earlier as additional candidates for Brady plan treatment do all of these auspicious circumstances exist. This is one reason I do not expect Brady to be a model.

I will conclude with some observations building on my introductory comments that debt rescheduling is best examined in a total political-economic context. A Mexican economic recovery is under way, at least based on one-year's data. GDP growth in 1989 was about 3 percent. This is not overwhelming by earlier Mexican standards, but is significant by the yardstick of the period since 1982. Continuation of this recovery requires reinvigoration of investment, particularly from domestic sources from which the bulk of such investment must come, but also from foreigners. Thus far there is no solid evidence that either domestic or foreign investment has been restored to earlier, pre-

crisis patterns.

Most creditor banks chose to exit from Mexico - they chose the two exit options, reduction of principal or of interest on old debt, and not the third option, the continuance option of providing new money. Mexico needs new money. It must finance the current account deficit in the balance of payments that is emerging with market opening and economic recovery. There is no excess capacity in many plants in precisely those industries that have sparked the export expansion of the past few years, and eliminating this bottleneck requires new investment.

The debt agreement will have succeeded if it contributes to enhancing confidence in Mexico's economic future - confidence of bankers and domestic and foreign investors. Most bankers, by opting to disengage, have not thus far exhibited confidence. I do not want to make too much of this because they will be back - despite the debt renegotiation - if the Mexican economy recovers, but they will be mostly absent during the next few crucial years. This is unfortunate.

There was some return of capital to Mexico last year, and some new investment, but not much. If this situation does not change, the debt agreement will not endure.

This is the context - the success of the Mexican experiment in structural adjustment and the confidence this instills in the domestic and international economic community - in which the 1990 debt agreement must be evaluated. I tend to be optimistic about Mexico. I think its current policies will restore the country to

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economic health. If you call me back next year, we can see whether I am correct, and whether the debt agreement accomplished its deeper purpose.

Thank you.

Senator SARBANES. Thank you very much.

Mr. Lowenthal, you ended with an invitation to be asked what ought to be done and I extend that invitation to you now.

Mr. LOWENTHAL. Thank you, Mr. Chairman.

Others are far better qualified than I to go into detail, but in general terms, I would make three or four points.

First, with respect to those countries that have already qualified for some debt relief under the Brady plan, those that I will refer to as the Brady bunch, the next phase is the need to get more new money to those countries. There is not enough money available from official sources and commercial banks and there is, therefore, a need for more creative approaches by the international financial institutions, to leverage private sector funds through more use of guarantees, cofinancing and the like. There's been some reference to that earlier this morning, particularly in the testimony of Mr. McPherson.

Second, with respect to those countries like Brazil and Argentina, which have not yet qualified and been really dealt with under the Brady plan, but are moving in one way or another toward the kinds of reforms that would make them eligible, there is need for much more rapid responsiveness. We can't afford to wait for successful implementation of a whole set of reforms or even probably for a full establishment of all the bona fide credentials that the reforms are really completely underway.

On the other hand, we obviously can't just up front make available all the kinds of resources. But we need to be ready to agree in advance on the kind of response that our Government and international financial institutions and other creditor governments will make in accord with preagreed achievements on a kind of game plan. There is need for more coordination between commercial banks and official institutions on what to expect in that sense, and what kind of standards to set.

Mr. Rhodes mentioned that the Brazilians are ready to talk or will be soon, and we need to be sure that the commercial banks and the international financial institutions and the Treasury and so on are as ready as well, in terms of an agreed approach.

Third, with respect to the poorer countries, I think we need to consider applying the principles of debt reduction to official debt, the kind of deal that was offered to the poorest of the African countries was agreed in principle at Toronto—we need to consider the applicability of this principle in some Western Hemisphere cases.

Now it seems to me in all these cases we basically need to keep our eye on the fundamental principle, which is that we are looking for ways to reduce the level of debt service to a level that is consistent with the possibility of long-term growth.

If I may anticipate my answer to the question that Senator Graham has asked to several witnesses, it seems to me that in evaluating the effectiveness of the approach and the response, we really need to look for not only the indicators that have been mentioned—and I certainly don't discount in any way the importance of the reforms that have been stressed by previous witnesses, and the economic growth rates and the level of inflation—but we also need to look at whether the level of debt service has been reduced to an extent that allows for investment, that allows for expanded

imports of the capital goods that will be necessary for a renewed growth phase, and that allows for sustainable growth. I would also add that the debt service needs to be reduced enough to provide a basis for continuing political support for the government in question.

One thing that was missing from the last set of discussions, and it is understandable that bankers are not looking at those issues in the same way that you in the Senate are and should—is the need to be very careful not to push the governments in a way which makes it necessary for them to choose between domestic political support and international financial blessings. They have got to be able to carry out a program that has a basis for political viability at home.

Senator SARBANES. I have a few more questions, but I will defer to Senator Graham.

Senator GRAHAM. Thank you very much, Mr. Chairman. I appreciate your courtesy and I regret that I am going to have to leave after asking the question that Mr. Lowenthal had anticipated.

That is, what are the standards that you would recommend to this committee or that you in your scholarly evaluation will be using to determine the effectiveness of the Brady plan?

Mr. WEINTRAUB. My answer really is not going to be terribly different from what some of the witnesses said in the previous panel.

I think we all look at a series of numbers. We look at growth rates. We look at distribution of growth. We look at the growth of exports. We look at the savings rates. We look at investment. All of those things I think have to be of examined.

Above all, though, I would look as to whether or not the debt settlement, in combination with the Government's own policies, has encouraged investors, both domestic and foreign, to have confidence in the country and either make new investments or return flight capital so that new investments can be made so that growth can be sustained.

The debt settlement contributes to that. It's not sufficient in and of itself. I am an economist and I look at economic growth issues as the essential element under which some of the stability that Abe has been talking about can be sustained.

Senator GRAHAM. Mr. Lowenthal?

Mr. LOWENTHAL. Senator Graham, I attempted to provide in effect my answer in anticipation. Knowing the committee's time limits, I don't want to go on at great length.

Basically, I certainly agree with Dr. Weintraub that the process of growth that reattracts investment is crucial. The money has to be generated for a process of sustaining growth. I was just attempting to add to what has been previously said, that Latin America needs a level of debt relief that allows for investment, for expanded imports, and for social programs to relieve some of the tremendous damages that have been done by the last few years.

Senator GRAHAM. Thank you, Mr. Chairman.

Senator SARBANES. Gentlemen, let me ask you whether you think in those instances in which the Brady plan has been put into practice with a particular country that it's been adequate and sufficient. In other words, if we could move all these countries through that process, get them out on the other side at sort of a comparable

place to where Mexico or now as we are anticipating Venezuela are, would you be encouraged about the situation or would you say, well, this has been done; it's better than it was, but it's inadequate and we're just going to be back into the soup again at some period of time?

Mr. WEINTRAUB. Let me pick up the second alternative you give—this is the best that can be done and we'll be back in the soup. Let me pick up the first part. While I think it's about the best that could have been done, in and of itself I don't think it's the answer to most of the problem. I don't know whether we'll be back in the soup again. I think we probably will be in the Philippines. I don't know about Venezuela and I think we will be in Mexico unless new money starts coming in or investment starts coming in in one way or another.

I guess my answer to your question, Senator, is that the Brady plan is just one element of a far bigger picture. It's a useful element. It reduces the annual debt service. It reduces the total debt. It gives certain assurances of stability in interest payments over future years—and in that sense it's valuable. But to focus just on that I think is insufficient.

Mr. LOWENTHAL. Mr. Chairman, I don't know whether this is fair, but I would answer your question by referring to something I think I heard you say at a meeting, perhaps at the Carter center or somewhere, and that is, comparing the response of the Reagan administration originally, when Donald Regan was the Secretary of the Treasury, to the breaking Latin American debt crisis, then the Baker plan and really the Brady plan, because I think I've never heard the matter put as succinctly as I believe you put it on that occasion.

The initial responsiveness of the U.S. Government to the tremendous thirst for external capital that was represented by the debt crisis was the response of Mr. Regan as Treasury Secretary saying to the Latin Americans, "Don't be thirsty." Then came the Baker plan of which the response was, "You're thirsty? Here's a glass."

Then came the Brady plan which provided a glass and a little liquid. This is a great improvement over the previous responses, for it is beginning to look at the Latin American side of the equation and the Third World side of the equation and not simply at the state of the commercial banks. But I am afraid that the response really still is not really adequate.

I was interested in comparing the testimony today and that presented before the House committee in February. Even in the Mexican case, which is the model country in terms of responsiveness to the standards that have been set forward, when you parse it all, the degree of relief is quite limited, compared with standards that have been set early in the discussions by the Mexican Government itself.

Now they trumpeted the agreement as the biggest achievement since the revolution. One understands in domestic political terms and even in terms of international legitimacy why they did that, but it may not even have been adequate in the Mexican case and other cases have been slow to follow.

Senator SARBANES. Who could and should be doing more? Is it one of those situations in which the problem has gotten so bad that

getting the most out of all the parties is still not enough to get you out of the problem so that you say, well, it's just very tough. We've sort of pushed everyone to their limits, but it's such a bad situation that's been allowed to develop that we are still having trouble getting out of it, or are there elements to this that could be pushed further and should do more and, if so, who?

Mr. WEINTRAUB. I think there's a lot to the effect that things have gotten so bad there's a limit to how far you can push. The banks have been pushed. They resented the Brady proposal quite deeply. They accept it now, but I've had conversations with bankers at the beginning of the process. They resented being pushed, but they consented. And they will get pushed further depending on how circumstances develop.

I think that the international institutions can be pushed a little more to play a bigger role. By this I mean the IMF, the World Bank, the Inter-American Development Bank, and other regional development banks. Bill Rhodes made those points.

Everybody seems to assume that any enhancements that come for new debt agreements must come from foreign countries and we all turn to Japan as the new economic power. It may be out of the question to all of you that the United States might put up some enhancements. But it seems to me we could also do something. This is our back yard. These are the countries that we care about and we just turn to everybody else for enhancements. In other words, I think we can do more.

In the case of the countries themselves, some of them can do more. I think Mexico has done about as much as any country can reasonably be asked to do. I don't know what combination of actions will restore expectations to a point that generates optimim that the country is going to grow and therefore worthy of new capital. The sufficient measures are not necessarily more debt relief. That may be useful but in and of itself it's not going to solve the development problem, although I would like to see a little bit more debt relief than was given. I think one percent of GDP is about one-third or one-fourth of what the Mexicans hoped they would get initially.

I think that confidence building is critical. Any measures that can begin to restore confidence is valuable. If the U.S. Government and the international development banks exhibited more confidence in Mexico, I think private investors might also.

Mr. LOWENTHAL. I agree with everything that Dr. Weintraub said. The one point I would add, Senator Sarbanes, having listened to the testimony since the beginning of the morning, is my sense is that there's just not enough of a sense of urgency about the problem.

The Venezuelan Government came in. It began to implement significant reforms. That generated a tremendous backlash, of the kind of riots that had never before been seen in Caracas and elsewhere in Venezuela. Now a year after Secretary Brady's announcement, there has been an agreement in principle worked out with Venezuela and we heard today that maybe in 6 months that agreement in principle can be translated into some effective agreements in practice.

That seems to me the kind of stately pace that we can't afford in terms of the depth of these problems in a number of the Latin American countries. And the reason I made the point about Brazil is I would hate to see in this extremely important country--very important for Latin America and for U.S. interests—a kind of "wait and see" attitude that "we'll work it out after we've seen how these reforms do," and "let's look at it for a year and maybe then develop an agreement in principle" and 6 months after that—I don't think we can afford that kind of thing.

So part of the problem is simply higher on the priority scale. When this country decides that a problem exists, when the Government, both the executive and the Congress, decide, that a problem deserves priority, it is able to move rather quickly and be responsive. I'm preaching to the choir, because you have taken the initiative in calling these hearings and you've been a great leader in the Senate on this, but you need to make your colleagues and the administration feel that sense of urgency.

Senator SARBANES. Well, actually, I think our problem is broader than just this issue. I think we're facing it now on arms control agreements, for instance. We need to conclude those arms control agreements and it's there to be done but everyone says, "Well, it's going to take 3 months or 6 months to work this out." By that time, we may lose an opportunity to build on something.

If we were fighting a war, it wouldn't take 3 or 6 months and I can't understand why waging the peace doesn't have an even greater intensity associated with it instead of sort of, well, maybe tomorrow or the next day or something of that sort.

So I agree with that observation very strongly. I also think it's a real confession of ineptitude if you can't handle more than one major item on your priority agenda at a time, particularly when we're living in a world of such fast change with a lot of opportunities open to us.

Professor Weintraub, let me ask you this question. Do you think in order to give this confidence sense to investors which you framed all in positive terms that there has to be a negative example, that that helps? In other words, you have this problem. You have countries that are important to us for reasons of trying to sustain democracy, but they don't do the economic reforms. In a sense, you have to say, well, you haven't done your reforms, there's no help; and then so you can draw a contrast between the countries that are really trying to reform, get their economies working, taking hard measures, to whom a lot of help is extended as compared with a country that's not doing that to which no or little help is extended.

Mr. WEINTRAUB. Mexican authorities are often pressed by their own nationals—I've been in meetings where the Mexican Treasury officials are pressed by people of the opposition party, "Why did you keep paying the debt? Why didn't you declare a moratorium of some kind, because by agreeing to pay the debt you put the Mexican people, particularly the poorest, through a social wringer that really had no precedent in Mexico since the revolution?" And the answer they give is the negative example. "Look what happened to Peru. Peru decided it would not pay its debt. But all creditors withdrew and Peru is far worse off today than it ever was before."

They also look at Argentina as a negative example. So I think there are plenty of negative examples out there. I guess I'm not sure that a negative example will convince an investor to positively put money in somewhere, unless the choice were only between those two places; but the investor obviously has many other choices as well.

Senator SARBANES. Do you have any observations on that, Mr. Lowenthal?

Mr. LOWENTHAL. I don't think so, Senator.

Senator SARBANES. Well, gentlemen, thank you very much. We really appreciate the careful work that's gone into both the written and the oral statements and also your patience in staying with us through the morning.

The hearing is adjourned.

[Whereupon, at 1:20 p.m., the hearing was adjourned.]

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